INTERNAL REVENUE
BULLETIN

IRS

# HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2016–20
May 16, 2016

**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

### REG–135734–14, page 853.

This document withdraws portions of a notice of proposed rulemaking published in the Federal Register on February 11, 2009. The withdrawn portions relate to the application of section 367(b) to transactions described in section 304(a)(1). This document also withdraws portions of a notice of proposed rulemaking published in the Federal Register on January 17, 2014. The withdrawn portions relate to the identification of certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation for purposes of section 7874.

### Announcement 2016–17, page 853.

This announcement provides notice that the IRS will not impose penalties under section 6721 or 6722 on eligible educational institutions with respect to Forms 1098–T, Tuition Statement, required to be filed and furnished for the 2016 calendar year under section 6050S if the institution reports the aggregate amount billed for qualified tuition and related expenses on Form 1098–T instead of the aggregate amount of payments received as required by section 212 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114–113 (129 Stat. 2242 (2015))(PATH).

### Rev. Proc. 2016–28, page 852.

This revenue procedure provides the 2017 inflation adjusted amounts for Health Savings Accounts under section 223 of the Internal Revenue Code.

### T.D. 9761, page 743.

This document contains temporary regulations that address transactions that are structured to avoid the purposes of sections 7874 and 367 of the Internal Revenue Code (the Code) and certain post-inversion tax avoidance transactions. These regulations affect certain domestic corporations and domestic partnerships whose assets are directly or indirectly acquired by a foreign corporation and certain persons related to such domestic corporations and domestic partnerships.

### T.D. 9763, page 799.

These regulations provide the method to be used to adjust the applicable Federal rates to determine the corresponding rates under section 1288 for tax-exempt obligations and the method to be used to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382.

### T.D. 9764, page 802.

This document contains final regulations relating to the penalty under section 6708 of the Internal Revenue Code for failing to make available lists of advisees with respect to reportable transactions.

### T.D. 9765, page 813.

These final regulations provide guidance on benefit suspension rules under section 432(e)(9) that permit certain multiemployer defined benefit pension plans in critical and declining funded status to reduce pension benefits payable to participants and beneficiaries if certain conditions are satisfied.

## ADMINISTRATIVE

### T.D. 9764, page 802.

This document contains final regulations relating to the penalty under section 6708 of the Internal Revenue Code for failing to make available lists of advisees with respect to reportable transactions.

**Finding Lists begin on page ii.**

# 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

*26 CFR 1.367(a)–3 & –3T, 1.367(b)–4 & –4T, 1.956–2 & –2T, 1.7701(l)–4T, 1.7874–1 & –1T, 1.7874–2 & 2T, 1.7874–3 & –3T, 1.7874–4T, 1.7874–6T – 1.7874–12T*

## T.D. 9761

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

## Inversions and Related Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that address transactions that are structured to avoid the purposes of sections 7874 and 367 of the Internal Revenue Code (the Code) and certain post-inversion tax avoidance transactions. These regulations affect certain domestic corporations and domestic partnerships whose assets are directly or indirectly acquired by a foreign corporation and certain persons related to such domestic corporations and domestic partnerships. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the 2016–18 issue of the **Bulletin**. The final regulations revise and add cross-references to coordinate the application of the temporary regulations.

DATES: *Effective Date*: These regulations are effective on April 8, 2016.

*Applicability Dates*: For dates of applicability, see §§ 1.304–7T(e), 1.367(a)–3T(c)(11)(ii), 1.367(b)–4T(h), 1.956–2T(i), 1.7701(l)–4T(h), 1.7874–1T(h)(2), 1.7874–2T(l)(2), 1.7874–3T(f)(2), 1.7874–4T(k)(1), 1.7874–6T(h), 1.7874–7T(h), 1.7874–8T(i), 1.7874–9T(g), 1.7874–10T(i), 1.7874–11T(f), and 1.7874–12T(b).

FOR FURTHER INFORMATION CONTACT: Regarding the regulations under sections 304, 367, and 7874, Shane M. McCarrick or David A. Levine, (202) 317-6937; regarding the regulations under sections 956 and 7701(l), Rose E. Jenkins, (202) 317-6934 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

I. *Overview*

This document contains regulations to address transactions commonly referred to as inversions and certain tax avoidance transactions related to inversions. An inversion may take many forms but has been generally described as a transaction that results in a domestic parent corporation of a multinational group being replaced with a foreign parent corporation. Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS–5–05) (May 31, 2005) (the JCT Explanation), at 342. An inversion is typically accompanied or followed by certain transactions that are intended "to remove income from foreign operations from the U.S. taxing jurisdiction." Id. In addition, the "corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions." Id.

Section 7874 and the regulations thereunder and § 1.367(a)–3(c) (concerning outbound transfers of domestic stock) are intended to address inversions. As described in Part II.F of this Background section, section 7874 generally applies to a transaction if three conditions are satisfied. When these conditions are satisfied, section 7874 either prevents the use of certain tax attributes to reduce the U.S. federal income tax owed on certain income or gain (inversion gain) recognized in transactions intended to remove foreign operations from the U.S. taxing jurisdiction, or treats the new foreign parent corporation as a domestic corporation for all purposes of the Code. As described in Part II.B.1 of this Background section, in certain inversions, § 1.367(a)–3(c) causes a United States person that is a shareholder of the domestic parent corporation to recognize gain (but not loss) on the exchange of its stock in the domestic corporation.

On September 22, 2014, the Department of the Treasury (Treasury Department) and the IRS issued Notice 2014–52, 2014–42 I.R.B. 712 (the 2014 notice), which announced the intention to issue regulations described therein to address certain transactions structured to avoid the purposes of section 7874 and § 1.367(a)–3(c) and certain post-inversion tax avoidance transactions. On November 19, 2015, the Treasury Department and the IRS issued Notice 2015–79, 2015–49 I.R.B. 775 (the 2015 notice), which announced the intention to issue regulations described therein to address certain additional transactions structured to avoid the purposes of section 7874 and § 1.367(a)–3(c) and certain additional post-inversion tax avoidance transactions. This document contains temporary regulations under sections 304, 367, 956, 7701(l), and 7874 of the Code.

The temporary regulations include the rules described in the two notices. Part I of the Explanation of Provisions section of this preamble explains the regulations addressing certain transactions structured to avoid the purposes of section 7874. Part II of the Explanation of Provisions section of this preamble explains the regulations addressing certain post-inversion tax avoidance transactions. In addition, the temporary regulations set forth new rules that address issues that were not discussed in either notice: (i) rules for identifying a foreign acquiring corporation when a domestic entity acquisition involves multiple steps (described in Part I.A of the Explanation of Provisions section of this preamble); (ii) rules that disregard stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions (described in Part I.B.3 of the Explanation of Provisions section of this preamble); (iii) rules that require a controlled foreign corporation (CFC) to recognize all realized gain upon certain transfers of assets described in section 351 that shift the ownership of those assets to a related foreign person that is not a CFC (described in Part II.B.3 of the Explanation of Provisions section of this preamble); and (iv) rules clarifying the definition of group income for purposes of the substantial business activities test (described in Part I.D.2 of the Explanation of Provisions section of this preamble). The temporary regulations also contain the rules described in Notice 88–108, 1988–2 C.B. 445; Notice 2008–91, 2008–43 I.R.B. 1001; Notice 2009–10, 2009–5 I.R.B. 419; and Notice 2010–12, 2010–4 I.R.B. 326, concerning the short-term obligation exception from United States property for purposes of section 956.

In addition, the temporary regulations provide a new definitions section under § 1.7874–12T that defines terms commonly used in certain of the regulations under sections 367(b), 956, 7701(l), and 7874. It is expected that future guidance projects will conform the nomenclature used in other portions of the existing section 7874 regulations with the nomenclature used in § 1.7874–12T.

The applicability dates for the rules that previously were announced in the 2014 notice and the 2015 notice are consistent with the dates previously announced. Thus, the rules described in the 2014 notice that address transactions that are structured to avoid the purposes of section 7874 apply to acquisitions completed on or after September 22, 2014, and the rules described in the 2015 notice that address transactions that are structured to avoid the purposes of section 7874 apply to acquisitions completed on or after November 19, 2015. Furthermore, the rules described in the 2014 notice that reduce the tax benefits of inversion transactions apply to post-inversion tax avoidance transactions completed on or after September 22, 2014, and the rules described in the 2015 notice that reduce the tax benefits of inversion transactions apply to post-inversion tax avoidance transactions completed on or after November 19, 2015. In both cases described in the preceding sentence, subject to one exception, the rules apply only if the inversion transaction was completed on or after September 22, 2014. The one exception is that, consistent with the 2014 notice, the rule described in Part II.B.4 of the Explanation of Provisions section of this preamble regarding the application of section 304(b)(5) is a generally applicable rule that applies without regard to whether there was an inversion transaction.

The new rules included in the temporary regulations, including any changes to rules described in the 2014 notice and the 2015 notice, generally apply to acquisitions or post-inversion tax avoidance transactions completed on or after April 4, 2016. In addition, and consistent with the announcement in the 2014 notice, the new rule described in Part II.B.3 of the Explanation of Provisions section of this preamble that reduces post-inversion tax benefits (by requiring a CFC to recognize all realized gain upon certain section 351 transfers) applies only if the inversion transaction was completed on or after September 22, 2014. However, no inference is intended as to the treatment of transactions described in the temporary regulations and this preamble under the law that applied before the applicability date of these regulations. The IRS may, where appropriate, challenge transactions, including those described in the temporary regulations and this preamble, under applicable Code or regulatory provisions or judicial doctrines.

Comments were received on the 2014 notice. One comment was received on the 2015 notice, but the comment was received after these temporary regulations had been substantially developed such that the Treasury Department and the IRS did not have time to fully consider the comment. The Treasury Department and the IRS will include this comment in the administrative record for the notice of proposed rulemaking on this subject in the 2016–18 issue of the **Bulletin** (REG–135734–14) and fully consider the comment in connection with finalization of the proposed regulations.

II. *Statutory and Regulatory Background*

A. *Section 304*

Section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and, in return for property, one of the corporations (acquiring corporation) acquires stock in the other corporation (issuing corporation) from the person (or persons) so in control, then (unless section 304(a)(2) applies) the property shall be treated as a distribution in redemption of the stock of the acquiring corporation.

Section 304(a)(2) provides that, for purposes of sections 302 and 303, if in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and the issuing corporation controls the acquiring corporation, then the property shall be treated as a distribution in redemption of the stock of the issuing corporation.

Section 304(b)(2) provides that, in the case of any acquisition to which section 304(a) applies, the determination of the amount that is a dividend (and the source thereof) shall be made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

Section 304(b)(5)(B) limits the earnings and profits taken into account under section 304(b)(2) when the acquiring corporation is foreign. Specifically, section 304(b)(5)(B) provides that no earnings and profits are taken into account for purposes of section 304(b)(2)(A) (and section 304(b)(2)(A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to section 304(b)(5)(B)) would neither be subject to U.S. federal income tax for the taxable year in which the dividends arise, nor be included in the earnings and profits of a CFC.

The Staff of the Joint Committee on Taxation's technical explanation of section 304(b)(5)(B) provides:

> The provision prevents the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation.

Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate

Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010 (JCX–46–10) (August 10, 2010), at 28.

Section 304(b)(5)(C) provides that the Secretary shall prescribe such regulations as are necessary to carry out the purposes of section 304(b)(5).

B. *Section 367*

1. Section 367(a)

Subject to certain exceptions, section 367(a)(1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on the transfer. Section 1.367(a)–3(c) provides an exception to the general rule of section 367(a)(1) for certain transfers by a United States person of stock or securities of a domestic corporation (the U.S. target company) to a foreign corporation. This exception only applies, however, if the U.S. target company complies with the reporting requirements in § 1.367(a)–3(c)(6) and if the four conditions set forth in § 1.367(a)–3(c)(1)(i) through (iv) are satisfied. The condition set forth in § 1.367(a)–3(c)(1)(iv) requires the active trade or business test (as defined in § 1.367(a)–3(c)(3)) to be satisfied, the requirements of which include the substantiality test (as defined in § 1.367(a)–3(c)(3)(iii)). The substantiality test is satisfied if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company. For this purpose, the fair market value of the transferee foreign corporation generally does not include assets acquired outside the ordinary course of business within the 36-month period preceding the exchange if they produce, or are held for the production of, passive income or are acquired for the principal purpose of satisfying the substantiality test.

2. Section 367(b)

Section 367(b)(1) provides that, in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary that are necessary or appropriate to prevent the avoidance of U.S. federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing the circumstances under which gain is recognized or deferred, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to the basis of stock or securities.

Regulations under section 367(b) generally provide that, if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation (foreign acquired corporation) by another foreign corporation in an exchange subject to section 367(b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount attributable to the stock of the foreign acquired corporation exchanged. See § 1.367(b)–4(b). Under § 1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of a foreign acquired corporation means the net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 if the stock were sold by the exchanging shareholder.

Specifically, subject to certain exceptions, § 1.367(b)–4(b)(1)(i) requires a deemed dividend inclusion if the exchange satisfies two conditions. First, immediately before the exchange, the exchanging shareholder is either (i) a United States person that is a section 1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation, and a United States person is a section 1248 shareholder with respect to such foreign corporation and the foreign acquired corporation. See § 1.367(b)–4(b)(1)(i)(A). Second, immediately after the exchange, either (i) the stock received by the exchanging shareholder is not stock in a CFC as to which the United States person described in the preceding sentence is a section 1248 shareholder, or (ii) the foreign acquiring corporation (for this purpose, as defined in § 1.367(b)–4(a)) or the foreign acquired corporation (in the case of an acquisition of the stock of the foreign acquired corporation) is not a CFC as to which the United States person is a section 1248 shareholder. See § 1.367(b)–4(b)(1)(i)(B).

Section 1.367(b)–4(c)(1) provides that a section 1248 amount included in income as a deemed dividend under § 1.367(b)–4(b) is not included as foreign personal holding company income (FPHCI) under section 954(c).

C. *Section 954*

Section 954 defines foreign base company income (FBCI), which generally is income earned by a CFC that is taken into account in computing the amount that a United States shareholder (within the meaning of section 951(b)) of the CFC must include in income under section 951(a)(1)(A). FBCI includes FPHCI, as defined in section 954(c), which, in turn, generally includes dividends. Section 954(c)(1)(A). However, dividends generally are excluded from FPHCI if they are received from a related person that (i) is a corporation created or organized under the laws of the same foreign country under the laws of which the CFC is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in that foreign country. Section 954(c)(3).

In addition, for certain taxable years, dividends received or accrued from another CFC that is a related person generally are excluded from the FPHCI of a CFC to the extent the dividends are attributable or properly allocable to income of the related person that is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States. Section 954(c)(6). Section 103(b)(1) of the Tax

Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345) added section 954(c)(6), which applied to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which these taxable years of the foreign corporation ended. Subsequently, section 954(c)(6) was amended five times to extend its applicability. Section 304(a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Public Law 110–343, 122 Stat. 3765); section 751(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111–312, 124 Stat. 3296); section 323(a) of the American Taxpayer Relief Act of 2012 (Public Law 112–240, 126 Stat. 2313); section 135(a) of Tax Increase Prevention Act of 2014 (Public Law 113–295, 128 Stat. 4010); and section 144 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114–113, 129 Stat. 2242). Currently, section 954(c)(6) applies to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2020, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end. Section 954(c)(6)(A) provides the Secretary with the authority to prescribe regulations as may be necessary or appropriate to carry out section 954(c)(6), including regulations as may be necessary or appropriate to prevent the abuse of its purposes.

D. *Section 956*

Section 956 determines the amount that a United States shareholder of a CFC must include in gross income with respect to the CFC under section 951(a)(1)(B). This amount is determined, in part, based on the average amount of United States property held, directly or indirectly, by the CFC at the close of each quarter during its taxable year. Subject to certain exceptions, section 956(c) generally defines United States property to include stock and obligations of United States persons that are related to the CFC. Sections 956(c)(1)(B) and (C) and 956(c)(2)(F) and (L). The term "obligation" is defined in § 1.956–2T(d). Section 956(e) grants the Secretary authority to prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956 through reorganizations or otherwise. In addition, section 956(d) grants the Secretary authority to prescribe regulations pursuant to which a CFC that is a pledgor or guarantor of an obligation of a United States person is considered to hold the obligation. Section 1.956–2(c) provides that a CFC that is a direct or indirect pledgor or guarantor of an obligation of a United States person is treated as holding the obligation. Section 3.01(a) of the 2014 notice discusses relevant legislative history of section 956.

E. *Section 7701*

Section 7701(l) grants the Secretary authority to issue regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such re-characterization is appropriate to prevent avoidance of any tax imposed under the Code. Section 3.02(a) of the 2014 notice discusses relevant legislative history of section 7701(l).

F. *Section 7874*

Under section 7874, a foreign corporation (foreign acquiring corporation) generally is treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions) three conditions are satisfied. First, the foreign acquiring corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (domestic entity acquisition). Second, after the domestic entity acquisition, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation (former domestic entity shareholders) by reason of holding stock in the domestic corporation (such percentage is referred to at times in this preamble as the "ownership percentage," and, the fraction used to calculate the ownership percentage is referred to at times in this preamble as the "ownership fraction"). And third, after the domestic entity acquisition, the expanded affiliated group (as defined in section 7874(c)(1)) that includes the foreign acquiring corporation (EAG) does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized (relevant foreign country), when compared to the total business activities of the EAG. Pursuant to section 7874(c)(1), an EAG is an affiliated group defined in section 1504(a), but without regard to the exclusion of foreign corporations in section 1504(b)(3) and using a more-than-50-percent ownership threshold in lieu of the 80-percent ownership threshold in section 1504(a). Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership. The domestic corporation or the domestic partnership described in this paragraph is referred to at times in this preamble as the "domestic entity."

The tax treatment of a domestic entity acquisition in which the EAG does not have substantial business activities in the relevant foreign country varies depending on the level of owner continuity. If the ownership percentage is at least 80, the foreign acquiring corporation is treated as a domestic corporation for all purposes of the Code pursuant to section 7874(b). If, instead, the ownership percentage is at least 60 but less than 80 (in which case the domestic entity acquisition is referred to in this preamble as an "inversion transaction"), the foreign acquiring corporation is respected as a foreign corporation, but, under section 7874(a)(1), the taxable income of the domestic entity and certain related United States persons (referred to as "expatriated entities" and defined in section 7874(a)(2)(A)) for any year that includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year. Section 7874(d)(1) defines the term "applicable period" as the period beginning on the first date properties are acquired as part of the domestic entity acquisition, and ending on the date that is 10 years after the last date properties are acquired as part of the domestic entity acquisition. In addition, section 7874(d)(2) generally provides that the term "inversion gain" means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity, provided the transfer or license takes place as part of the domestic entity acquisition or, under subparagraph (B), after the domestic entity acquisition if the transfer or license is to a foreign related person. Section 7874(d)(2) provides that subparagraph (B) does not apply to property described in section 1221(a)(1) (generally, property that is inventory) in the hands of the expatriated entity.

Section 7874(d)(3) provides that the term "foreign related person" means, with respect to any expatriated entity, a foreign person that is (i) related (within the meaning of section 267(b) or 707(b)(1)) to the entity, or (ii) under the same common control (within the meaning of section 482) as the entity.

Section 7874(e)(2)(A) provides that, in the case of an expatriated entity that is a partnership, section 7874(a)(1) shall apply at the partner rather than the partnership level.

Under section 7874(c)(4), a transfer of properties or liabilities (including by contribution or distribution) is disregarded if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. In addition, section 7874(c)(6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock. Finally, section 7874(g) grants the Secretary authority to provide regulations necessary to carry out section 7874, including regulations providing for such adjustments to the application of section 7874 as are necessary to prevent the avoidance of the purposes of section 7874, including the avoidance of such purposes through (i) the use of related persons, pass-through or other non-corporate entities, or other intermediaries, or (ii) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.

## Explanation of Provisions

### I. *Regulations Addressing Certain Transactions that Are Structured to Avoid the Purposes of Section 7874*

This Part I describes rules for (i) identifying domestic entity acquisitions and foreign acquiring corporations in certain multiple-step transactions; (ii) calculating the ownership percentage and, more specifically, disregarding certain stock of the foreign acquiring corporation for purposes of computing the denominator of the ownership fraction and, in addition, taking into account certain non-ordinary course distributions (NOCDs) made by a domestic entity for purposes of computing the numerator of the ownership fraction; (iii) determining when certain stock of a foreign acquiring corporation is treated as held by a member of the EAG; and (iv) determining when an EAG has substantial business activities in a relevant foreign country.

### A. *Multiple-step acquisition of property of a domestic entity*

#### 1. Background

Section 1.7874–2(c) provides guidance on the types of transactions that constitute a direct or indirect acquisition by a foreign corporation of properties held directly or indirectly by a domestic entity and that therefore potentially result in a domestic entity acquisition. Section 1.7874–2(c)(1) sets forth a non-exclusive list of the types of transactions that generally result in an indirect acquisition of properties of a domestic entity. In addition, § 1.7874–2(c)(2) provides that when a foreign corporation acquires stock of another foreign corporation, which, in turn, directly or indirectly owns stock or a partnership interest in a domestic entity, the acquisition by the foreign corporation does not constitute an indirect acquisition of any properties held by the domestic entity. Absent § 1.7874–2(c)(2), the foreign corporation's acquisition of the stock of the other foreign corporation would be an indirect acquisition of properties of the domestic entity. However, because the domestic entity had a foreign parent before the acquisition, these types of transactions typically do not give rise to the policy concerns that motivated Congress to enact section 7874, and therefore they generally are not treated as indirect acquisitions of properties of a domestic entity. This rule does not, however, address multiple related acquisitions of the properties of a domestic entity.

Section 1.7874–2(f) provides a non-exclusive list of stock of a foreign corporation that is described in section 7874(a)(2)(B)(ii) (that is, stock of the foreign acquiring corporation held by former domestic entity shareholders or former domestic entity partners by reason of holding stock or partnership interests in the domestic entity; at times, referred to in this preamble as "by-reason-of stock").

#### 2. Transactions at Issue

The Treasury Department and the IRS are concerned that taxpayers may take the position that certain transactions are not domestic entity acquisitions even though the transactions give rise to the policy concerns that motivated Congress to enact section 7874. This could occur, for example, when a foreign corporation (initial acquiring corporation) acquires substantially all of the properties held by a domestic entity (the initial acquisition) in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under section 7874(b) (for example, because the ownership percentage is less than 80 or because the EAG purports to meet the substantial business activities exception in § 1.7874–3), and, pursuant to a plan that includes the initial acquisition (or a series of related transactions), another foreign corporation (subsequent acquiring corporation) acquires substantially all of the properties of the initial acquiring corporation (the subsequent acquisition). In these cases, a taxpayer may take the position that the form of the transactions is respected for U.S. federal income tax purposes and that § 1.7874–2(c)(2) prevents the subsequent acquiring corporation from being considered to have indirectly acquired the properties of the domestic entity pursuant to the subsequent acquisition. Under this position, although the initial acquisition would be a domestic entity acquisition and the initial acquiring corporation would be a foreign acquiring corporation, the subsequent acquisition would not be a domestic entity acquisition, and the subsequent acquiring corporation would not be a foreign acquiring corporation. Moreover, for purposes of computing the ownership percentage, a taxpayer may assert that former domestic entity shareholders do not hold stock of the subsequent acquiring corporation by reason of holding stock in the domestic entity and, instead, hold stock of the subsequent acquiring corporation only by reason of holding stock in the initial acquiring corporation.

In certain cases, these positions are contrary to the purposes of section 7874, including the purposes of (i) the third-country rule set forth in § 1.7874–9T (and described in Section B.4 of this Part I), if the subsequent acquiring corporation and the initial acquiring corporation are subject to tax as residents of different foreign countries, or (ii) the substantial business activities exception in § 1.7874–3 if the EAG has substantial business activities in the foreign country in which, or under the laws of which, the initial acquiring corporation is created or organized but does not have substantial business activities in the foreign country in which, or under the laws of which, the subsequent acquiring corporation is created or organized.

3. Multiple-Step Acquisition Rule

To address the concerns described in Section 2 of this Part I.A, the temporary regulations provide a rule (the multiple-step acquisition rule) that treats the subsequent acquisition as a domestic entity acquisition and the subsequent acquiring corporation as a foreign acquiring corporation. § 1.7874–2T(c)(4)(i). When the multiple-step acquisition rule applies, the temporary regulations treat stock of the subsequent acquiring corporation received, pursuant to the subsequent acquisition, in exchange for stock of the initial acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, stock of the initial acquiring corporation that, as a result of the initial acquisition, is by-reason-of stock) as stock of the subsequent acquiring corporation held by reason of holding stock in the domestic entity. § 1.7874–2T(f)(1)(iv).

Further, if, pursuant to the same plan (or a series of related transactions), a foreign corporation directly or indirectly acquires substantially all of the properties held by a subsequent acquiring corporation in a transaction that occurs after the subsequent acquisition, the principles of the multiple-step acquisition rule apply to also treat the further acquisition as a domestic entity acquisition and the foreign corporation that made such acquisition as a foreign acquiring corporation. § 1.7874–2T(c)(4)(iii). For example, if, pursuant to a plan, a foreign corporation (F1) acquires substantially all of the properties held by a domestic corporation, followed by another foreign corporation (F2) acquiring substantially all of the properties held by F1, followed, in turn, by another foreign corporation (F3) acquiring substantially all of the properties held by F2, then the multiple-step acquisition rule also would treat F3's acquisition of F2's properties as a domestic entity acquisition and F3 as a foreign acquiring corporation. In such a case, the principles of the multiple-step acquisition rule would apply in a similar manner to treat stock of F3 as by-reason-of stock to the extent the F3 stock is received in exchange for F2 stock that is itself treated as by-reason-of stock under the multiple-step acquisition rule.

The multiple-step acquisition rule applies in a similar manner when the domestic entity is a domestic partnership.

These rules do not affect the application of section 7874 to the initial acquisition. As a result, section 7874 may apply to both the initial acquisition and the subsequent acquisition. In addition, and like other guidance under § 1.7874–2, the multiple-step acquisition rule applies solely for section 7874 purposes. Accordingly, this rule does not modify general tax principles (such as the step-transaction doctrine) or other rules or guidance that may apply to related transactions.

B. *Calculation of the ownership percentage*

1. Clarification of § 1.7874–4T

a. § 1.7874–4T, in general

Under section 7874(c)(2)(B) (statutory public offering rule), stock of a foreign acquiring corporation that is sold in a public offering related to a domestic entity acquisition described in section 7874(a)(2)(B)(i) is excluded from the denominator of the ownership fraction. The statutory public offering rule furthers the policy that section 7874 is intended to curtail domestic entity acquisitions that "permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion." S. Rep. No. 192, 108th Cong., 1st. Sess., at 142 (2003); JCT Explanation, at 343.

Section 1.7874–4T modifies the statutory public offering rule. The preamble to § 1.7874–4T provides that "the IRS and the Treasury Department believe that stock of the foreign acquiring corporation transferred in exchange for certain property in a transaction related to the acquisition, but not through a public offering, presents the same opportunity to inappropriately reduce the ownership fraction." TD 9654, published on January 17, 2014, in the **Federal Register** (79 FR 3094, at 3095). Accordingly, § 1.7874–4T(b) provides that, subject to a de minimis exception, "disqualified stock" is not included in the denominator of the ownership fraction. Disqualified stock generally includes stock of the foreign acquiring corporation that is transferred to a person (other than the domestic entity) in exchange for "nonqualified property." The term "nonqualified property" means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations (for example, obligations owed by members of the EAG), or (iv) any other property acquired in a transaction (or series of transactions) related to the domestic entity acquisition with a principal purpose of avoiding the purposes of section 7874. This preamble refers at times to the property described in clauses (i), (ii), and (iii) of the preceding sentence collectively as "specified nonqualified property" and to the property described in clause (iv) as "avoidance property." For this purpose, the term "marketable securities" has the meaning set forth in section 453(f)(2), except that the term does not include stock of a corporation or an interest in a partnership that becomes a member of the EAG in a transaction (or series of transactions) related to the domestic entity acquisition, unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of section 7874.

b. Clarification

Section 2.03(b) of the 2015 notice provides that § 1.7874–4T will be clarified in certain respects. The temporary regulations implement these clarifications. Accordingly, with respect to the definition of nonqualified property, the temporary regulations clarify that avoidance property means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of specified nonqualified property. See § 1.7874–4T(j), *Example 3*. Second, the temporary regulations remove the phrase "in a transaction (or series of transactions) related to the acquisition" from the definition of avoidance property. See § 1.7874–4T(i)(7)(iv). Third, the temporary regulations remove the phrase "unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of section 7874" from the definition of "marketable securities." See § 1.7874–4T(i)(6). Finally, the temporary regulations clarify *Example 1* and *Example 2* of § 1.7874–4T(j) by including a reference to section 7874(c)(4).

In addition, the temporary regulations update the de minimis exception in § 1.7874–4T(d)(1) to reflect the passive assets rule (described in Section 2 of this Part I.B) and the NOCD rule (described in Section 5 of this Part I.B), and to also conform the exception to the de minimis exceptions in §§ 1.7874–7T(c) and 1.7874–10T(d).

2. Passive Assets Rule

a. Overview of the 2014 notice

Section 2.01(b) of the 2014 notice announced that future regulations would include a rule (the passive assets rule) that would exclude from the denominator of the ownership fraction stock of a foreign acquiring corporation that is attributable to certain passive assets, but only if, after the domestic entity acquisition and all related transactions are complete, more than 50 percent of the gross value of all foreign group property constitutes certain passive assets (referred to in the notice and temporary regulations as "foreign group nonqualified property"). See Section b of this Part I.B.2 for the definition of foreign group property and foreign group nonqualified property. The temporary regulations implement the passive assets rule described in the 2014 notice, subject to the modifications described in Section c of this Part I.B.2.

The 2014 notice provides that the amount of stock that will be excluded under the passive assets rule is equal to the product of (i) the value of the stock of the foreign acquiring corporation, other than stock that is described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) and stock that is excluded from the denominator of the ownership fraction under either § 1.7874–1(b) (because it is held by a member of the EAG) or § 1.7874–4T(b) (because it is disqualified stock); and (ii) the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is the gross value of all foreign group nonqualified property, and the denominator is the gross value of all foreign group property. However, property received by the foreign acquiring corporation that gives rise to stock that is excluded from the ownership fraction under § 1.7874–4T(b) is excluded from both the numerator and the denominator of the foreign group nonqualified property fraction, as applicable.

In addition, the 2014 notice provides that the passive assets rule will incorporate the principles of § 1.7874–4T(h) (regarding the interaction of the EAG rules with the rule that excludes disqualified stock from the denominator of the ownership fraction) with respect to stock of the foreign acquiring corporation that is excluded under the passive assets rule.

b. Foreign group property and foreign group nonqualified property

The 2014 notice provides that foreign group property means any property (including property that gives rise to disqualified stock upon application of § 1.7874–4T) held by the EAG after the domestic entity acquisition and all transactions related to that acquisition are complete, other than the following property: (i) property that is directly or indirectly acquired in the domestic entity acquisition and that, at the time of the domestic entity acquisition, was held directly or indirectly by the domestic entity; and (ii) to avoid double counting, stock or a partnership interest in a member of the EAG and an obligation described in § 1.7874–4T(i)(7)(iii)(A) (that is, an obligation of a member of the EAG).

With respect to foreign group nonqualified property, the 2014 notice provides that the term generally means foreign group property that is described in § 1.7874–4T(i)(7) other than property that gives rise to income described in section 1297(b)(2)(A) (the banking exception under the passive foreign investment company (PFIC) rules) or section 954(h) or (i) (subpart F exceptions for qualified banking or financing income and for qualified insurance income, respectively), determined by substituting the term "foreign corporation" for the term "controlled foreign corporation." In addition, a special rule treats certain property (referred to as "substitute property") that would not be foreign group nonqualified property under the general rule as foreign group nonqualified property if, in a transaction related to the acquisition, such property is acquired in exchange for other property that would be foreign group nonqualified property under the general rule.

Section 4.01(b)(i) of the 2015 notice modifies the general definition of foreign group nonqualified property to also exclude from that definition property that gives rise to income described in section 1297(b)(2)(B) (the PFIC insurance exception). Further, section 4.01(b)(ii) of the 2015 notice provides that the general definition of foreign group nonqualified property does not include property (i) held by a domestic corporation that is subject to tax as an insurance company under subchapter L, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business; or (ii) that gives rise to income described in section 954(h), determined by substituting the term "domestic corporation" for the term "controlled foreign corporation," and without regard to the phrase "located in a country other than the United States" in section 954(h)(3)(A)(ii)(I) and without regard to any inference that the tests in section 954(h) should be calculated or determined without taking into account transactions with customers located in the United States. In all three of these cases, however, the special rule for substitute property could still apply.

c. Regulations implementing the passive assets rule

Section 1.7874–7T sets forth the passive assets rule as described in the 2014 notice and the 2015 notice, subject to certain modifications, in part, to address comments received.

i. De Minimis Exception

A comment noted that certain rules described in the 2014 notice could cause section 7874 to apply to a domestic entity acquisition even though the former domestic entity shareholders or former domestic entity partners, as applicable, actually own no, or only a de minimis amount of, stock in the foreign acquiring corporation after the domestic entity acquisition. In the context of the passive assets rule this could occur, for example, if a foreign acquiring corporation, which holds only cash that does not give rise to disqualified stock under § 1.7874–4T, acquires the stock of the domestic entity in exchange for a portion of the cash and a small amount of stock of the foreign acquiring corporation. Because the foreign group property would be comprised entirely of the remaining cash held by the foreign acquiring corporation, 100 percent of the gross value of all foreign group property would constitute foreign group nonqualified property. Accordingly, absent a de minimis exception, all of the stock of the foreign acquiring corporation, other than stock described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock), would be excluded from the denominator of the ownership fraction pursuant to the passive assets rule, resulting in an ownership fraction of 100 percent. In response to the comment, and for reasons similar to the reasons for the de minimis exceptions in § 1.7874–4T and the NOCD rule (described in Section 5 of this Part I.B), the Treasury Department and the IRS have determined that there should be a de minimis exception to the passive assets rule.

Accordingly, § 1.7874–7T(c) provides a de minimis exception when two requirements are satisfied: (i) first, the ownership percentage— determined without regard to the application of the passive assets rule, § 1.7874–4T(b), and the NOCD rule (described in Section 5 of this Part I.B)—is less than five (by vote and value); and (ii) second, on the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete (the completion date), former domestic entity shareholders or former domestic entity partners, as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the EAG.

ii. Assets Upstream of the Foreign Acquiring Corporation

The 2014 notice would treat property held by an EAG member as foreign group property regardless of whether the foreign acquiring corporation directly or indirectly owned an interest in the property. Thus, in cases in which the foreign acquiring corporation is not the common parent of the EAG, the 2014 notice could treat property as foreign group property even though the value of the property is not reflected in the value of the stock of the foreign acquiring corporation.

The Treasury Department and the IRS have concluded that foreign group property should not include property held by EAG members if the value of such property is not reflected in the value of the stock of the foreign acquiring corporation. In order to effectuate this policy, the temporary regulations limit foreign group property to property held by members of the "modified expanded affiliated group." See § 1.7874–7T(f)(2) (defining foreign group property). When the foreign acquiring corporation is not the common parent corporation, the modified EAG is the EAG redetermined as if the foreign acquiring corporation were the common parent corporation. See § 1.7874–7T(f)(4) (defining modified expanded affiliated group).

In connection with this change, the temporary regulations also modify the definition of foreign group property provided in the 2014 notice to exclude only stock or partnership interests in members of the modified EAG and obligations of such members, since the issue of double-counting only arises with respect to those interests.

iii. Certain Nonqualified Property that Gives Rise to Disqualified Stock

A comment questioned whether, for purposes of the more-than-50-percent threshold test, foreign group property should include certain nonqualified property (within the meaning of § 1.7874–4T(i)(7)) received by the EAG in a transaction related to the domestic entity acquisition. In particular, the comment noted that nonqualified property received by the EAG in such a transaction may (i) if received in exchange for stock of the foreign acquiring corporation, give rise to disqualified stock (within the meaning of § 1.7874–4T(c)) that is excluded from the denominator of the ownership fraction under § 1.7874–4T(b), and (ii) because such property is foreign group nonqualified property, increase the likelihood that the more-than-50-percent threshold will be exceeded and thus that additional stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction under the passive assets rule.

The Treasury Department and the IRS have determined that the more-than-50-percent threshold test should apply without regard to whether all or a portion of the foreign group nonqualified property was received in a transaction related to the domestic entity acquisition. The more-than-50-percent threshold test is an on-off switch that is intended to determine whether, after the domestic entity acquisition and all related transactions are complete, a majority of the value of the stock of the foreign acquiring corporation is attributable to nonqualified property; other aspects of the passive assets rule coordinate its operation with the other anti-abuse rules under section 7874. Accordingly, the temporary regulations confirm that, for purposes of the more-than-50-percent threshold test, foreign group property includes nonqualified property that gives rise to disqualified stock that is excluded from the denominator of the ownership fraction pursuant to § 1.7874–4T(b). See

§ 1.7874–7T(f)(2). However, as is the case under the 2014 notice, § 1.7874–7T(b) does not exclude from the denominator of the ownership fraction any stock of the foreign acquiring corporation that is attributable to such property. See § 1.7874–7T(f)(3). Stock attributable to such property is instead excluded from the denominator of the ownership fraction under § 1.7874–4T(b).

iv. Valuing Foreign Group Property

A comment recommended providing a safe harbor to facilitate the valuation of foreign group property. The comment noted that the value of certain property, particularly illiquid property, may be difficult or costly to determine, especially in the case of a foreign acquiring corporation that is not publicly traded.

After considering this comment, the Treasury Department and the IRS decline to provide such a safe harbor. A domestic entity acquisition is likely to be an infrequent occurrence for a foreign acquiring corporation. Furthermore, as a general matter, the value of foreign group property must be established in order to determine the amount of stock of the foreign acquiring corporation that must be provided in the domestic entity acquisition. Therefore, it should not be unduly burdensome to determine the aggregate gross value of foreign group property and foreign group nonqualified property.

v. Exclusions from General Definition of Foreign Group Nonqualified Property

A comment requested that the regulations clarify that the exclusions from the general definition of foreign group nonqualified property for certain property that gives rise to income described in section 954(h) or (i) apply regardless of whether section 954(h) or (i) sunset. However, section 128 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114–113, 129 Stat. 2242) made sections 954(h) and (i) permanent. Therefore, this comment is no longer relevant and is not adopted.

Another comment requested that the Treasury Department and the IRS clarify that references in the regulations to section 954(h) or (i) or section 1297(b)(2)(A) or (B) incorporate the principles of any regulations or other guidance issued pursuant to those Code sections. In this regard, the Treasury Department and the IRS note that as a general matter, unless otherwise indicated, a reference in a regulation to a Code section implicitly includes any regulations or other guidance issued pursuant to that Code section. Accordingly, the comment is not adopted.

vi. Treatment of Partnerships

The 2014 notice did not explicitly address the treatment of partnerships under the passive assets rule. Similar to § 1.7874–4T(g), the temporary regulations provide that, if one or more members of an EAG (for this purpose, taking into account only members of the modified EAG as described in Section ii of this Part I.B.2.c) own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, then, for purposes of the passive assets rule, the partnership is treated as a corporation that is a member of the EAG (deemed corporation rule). See § 1.7874–7T(d).

The temporary regulations implementing the passive assets rule do not include a rule analogous to that provided in § 1.7874–3(e)(1), which treats certain corporate partners of a partnership that owns stock of a foreign acquiring corporation as members of the EAG for purposes of applying the substantial business activities test. Such a rule is not necessary because, as described in Section ii of this Part I.B.2.c, assets that are upstream of the foreign acquiring corporation are not taken into account as foreign group property for purposes of applying the passive assets rule.

3. Acquisitions of Multiple Domestic Entities

a. Transactions at issue

The Treasury Department and the IRS are concerned that a single foreign acquiring corporation may avoid the application of section 7874 by completing multiple domestic entity acquisitions over a relatively short period of time, in circumstances where section 7874 would otherwise have applied if the acquisitions had been made at the same time or pursuant to a plan (or series of related transactions). In these situations, the value of the foreign acquiring corporation increases to the extent it issues stock in connection with each successive domestic entity acquisition, thereby enabling the foreign acquiring corporation to complete another, potentially larger, domestic entity acquisition to which section 7874 will not apply. In some cases, a substantial portion of the value of a foreign acquiring corporation may be attributable to its completion of multiple domestic entity acquisitions over the span of just a few years, with that value serving as a platform to complete still larger subsequent domestic entity acquisitions that avoid the application of section 7874. That is, the ownership percentage determined with respect to a subsequent domestic entity acquisition may be less than 60, or less than 80, if the shares of the foreign acquiring corporation issued in prior domestic entity acquisitions are respected as outstanding (thus, included in the denominator but not the numerator) when determining the ownership fraction.

Section 7874 is intended to address transactions in which a domestic parent corporation of a multinational group is replaced with a foreign parent corporation while "permit[ting] corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion." S. Rep. No. 192, at 142 (2003); JCT Explanation, at 343. To further this policy, various rules under section 7874 exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation that otherwise would inappropriately reduce the ownership fraction. For example, the statutory public offering rule of section 7874(a)(2)(B) excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation that is sold for cash in a public offering related to the domestic entity acquisition. For the same reason, rules under §§ 1.7874–4T and 1.7874–7T exclude from the denominator of the ownership fraction certain stock of the foreign acquiring corporation that is transferred in exchange for, or otherwise attributable to, passive assets or other nonqualified property.

The Treasury Department and the IRS have concluded that it is not consistent with the purposes of section 7874 to permit a foreign acquiring corporation to reduce the ownership fraction for a domestic entity acquisition by including stock issued in connection with other recent domestic entity acquisitions. Moreover, the Treasury Department and the IRS do not believe that the application of section 7874 in these circumstances should depend on whether there was a demonstrable plan to undertake the subsequent domestic entity acquisition at the time of the prior domestic entity acquisitions. Therefore, and consistent with the policies underlying the other stock exclusion rules under section 7874, the Treasury Department and the IRS have determined that stock of the foreign acquiring corporation that was issued in connection with certain prior domestic entity acquisitions occurring within a 36-month look-back period should be excluded from the denominator of the ownership fraction.

b. Disregard of stock attributable to certain domestic entity acquisitions

To address these concerns, the temporary regulations provide a rule under section 7874(c)(6) and (g) that, for purposes of calculating the ownership percentage by value with respect to a domestic entity acquisition (the relevant domestic entity acquisition), excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain prior domestic entity acquisitions. This rule (the multiple domestic entity acquisition rule) applies if, within the 36-month period ending on the signing date with respect to the relevant domestic entity acquisition, the foreign acquiring corporation (or a predecessor) completed one or more other domestic entity acquisitions that are not excluded under an exception (each such other domestic entity acquisition, a prior domestic entity acquisition). For this purpose, the signing date is the first date on which the contract to effect the relevant domestic entity acquisition is binding, or if another binding contract to effect a substantially similar acquisition was terminated with a principal purpose of avoiding section 7874, the first date on which such other contract was binding. In general, a domestic entity acquisition is excluded from the definition of a prior domestic entity acquisition if (i) the ownership percentage with respect to such domestic entity acquisition was less than five, and (ii) the fair market value of the by-reason-of stock received by the former domestic entity shareholders or former domestic entity partners did not exceed $50 million.

In general, the amount of foreign acquiring corporation stock that is excluded under the multiple domestic entity acquisition rule is based on the current value of the shares of foreign acquiring corporation stock that were issued in the prior domestic entity acquisition, adjusted to reflect intervening redemptions of stock as well as certain other changes in the capital structure of the foreign acquiring corporation. The Treasury Department and the IRS have determined that this approach, which takes into account subsequent fluctuations in value attributable to the prior domestic entity acquisition, best reflects the policies underlying section 7874, including the ownership fraction.

The temporary regulations provide a three-step process to determine the excluded amount for each prior domestic entity acquisition. First, the total number of shares of stock of the foreign acquiring corporation, within each separate share class (relevant share class), that was described in section 7874(a)(2)(B)(ii) as a result of the prior domestic entity acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied) must be calculated (total number of prior acquisition shares). For this purpose, it is not relevant whether a share is outstanding at the time of the relevant domestic entity acquisition.

Second, for each relevant share class, the total number of prior acquisition shares must be adjusted to account for redemptions (within the meaning of section 317(b)) of shares that occur during the redemption testing period (each such share, a redeemed share) and that are attributed, on a pro rata basis, to the prior acquisition shares. In general, the redemption testing period is the period beginning on the day after the completion date of the prior domestic entity acquisition and ending on the day prior to the completion date of the relevant domestic entity acquisition (the general redemption testing period). § 1.7874–8T(e)(1). The number of redeemed shares is then multiplied by the redemption fraction (such product, the allocable redeemed shares). § 1.7874–8T(d)(1). The numerator of the redemption fraction is generally the total number of prior acquisition shares, and the denominator is the sum of: (i) the number of outstanding shares of the foreign acquiring corporation stock as of the end of the last day of the redemption testing period, and (ii) the number of redeemed shares during the redemption testing period.

By ending the redemption testing period on the day prior to the completion date of the relevant domestic entity acquisition, shares issued on such completion date would not dilute the portion of a prior redemption that is allocated to the prior acquisition shares. However, to prevent other stock issuances that occur after a particular redemption from diluting the amount of allocable redeemed shares, a foreign acquiring corporation may establish a reasonable method for dividing the general redemption testing period into shorter periods (each such shorter period, a redemption testing period). § 1.7874–8T(e)(2). In these cases, to account for the fact that the total number of prior acquisition shares is reduced by the allocable redeemed shares for each redemption testing period, the numerator of the redemption fraction for a redemption testing period is the total number of prior acquisition shares less the sum of the number of allocable redeemed shares for prior redemption testing periods. § 1.7874–8T(d)(2)(i).

Finally, for each relevant share class, the total number of prior acquisition shares, reduced to take into account redemptions, is multiplied by the fair market value of a single share of stock of the relevant share class, as of the completion date of the relevant domestic entity acquisition (such product, an excluded amount). § 1.7874–8T(c). The total amount of stock of the foreign acquiring corporation excluded from the denominator of the ownership fraction is the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class. § 1.7874–8T(b).

The temporary regulations also require appropriate adjustments to be made to take into account changes in a foreign acquiring corporation's capital structure to ensure that the amount of stock excluded under the multiple domestic entity acquisition rule properly reflects the value attributable to prior domestic entity acquisitions. See § 1.7874–8T(f).

The multiple domestic entity acquisition rule applies after taking into account the rule in § 1.7874–2(e). The rule in § 1.7874–2(e) applies when a foreign acquiring corporation completes two or more domestic entity acquisitions pursuant to a plan (or series of related transactions). In such a case, for purposes of section 7874(a)(2)(B)(ii), the acquisitions are treated as a single acquisition, and the domestic entities are treated as a single domestic entity. Thus, for example, if two acquisitions that would separately qualify as a relevant domestic entity acquisition and a prior domestic entity acquisition are subject to § 1.7874–2(e), they are treated as a single acquisition and, as a result, would not be subject to the multiple domestic entity acquisition rule. Similarly, if two acquisitions that would separately be treated as two prior domestic entity acquisitions are subject to § 1.7874–2(e), they are treated as a single prior domestic entity acquisition for purposes of applying the multiple domestic entity acquisition rule.

### 4. Third-Country Rule

#### a. Background

Section 2.02(b) of the 2015 notice announces that the Treasury Department and the IRS intend to issue regulations providing a rule (the third-country rule) that will apply to certain domestic entity acquisitions in which a domestic entity combines with an existing foreign corporation under a foreign parent corporation that is a tax resident of a "third country" (that is, a foreign country other than the foreign country of which the existing foreign corporation is subject to tax as a resident). The 2015 notice provides that the third-country rule will apply when four requirements are satisfied. First, in a transaction (referred to in the 2015 notice as a "foreign target acquisition" but in this preamble and the temporary regulations as a "foreign acquisition") related to the domestic entity acquisition, the foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by another foreign corporation (the acquired foreign corporation). Second, the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign acquisition exceeds 60 percent of the gross value of all foreign group property, other than foreign group nonqualified property, held by the EAG on the completion date (the gross value requirement). Third, the tax residence of the foreign acquiring corporation is not the same as that of the acquired foreign corporation, as determined before the foreign acquisition and any related transaction (the tax residency requirement). And fourth, the ownership percentage, determined without regard to the third-country rule, must be at least 60 but less than 80 (the domestic entity ownership requirement). As explained in Section b of this Part II.B.4, the temporary regulations retain the first, third, and fourth requirements described in the 2015 notice but replace the second requirement with a new requirement.

When these requirements are satisfied, the 2015 notice provides that the third-country rule will exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation held by former shareholders of the acquired foreign corporation by reason of holding stock in the acquired foreign corporation (based on the principles of section 7874(a)(2)(B)(ii), which describes by-reason-of stock).

#### b. Regulations implementing the third-country rule

Section 1.7874–9T sets forth the third-country rule as described in the 2015 notice, subject to certain modifications.

The temporary regulations replace the gross value requirement contained in the 2015 notice with a continuity of interest requirement (referred to as the "foreign ownership percentage"). See § 1.7874–9T(d)(3) and (4). In general, this requirement is satisfied if at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the acquired foreign corporation by reason of holding stock in the acquired foreign corporation, as determined under the principles of section 7874(a)(2)(B)(ii), with certain modifications. § 1.7874–9T(e)(3) and (4). For this purpose, stock of the foreign acquiring corporation held by former domestic entity shareholders (or former domestic entity partners) is not taken into account. See § 1.7874–9T(e)(3)(i). Because a domestic entity acquisition is disregarded for this purpose, it does not dilute the foreign ownership percentage. The temporary regulations implement this modification by requiring that there be a covered foreign acquisition, generally defined as a transaction in which there is an acquisition of substantially all of the properties of a foreign corporation (that is, a foreign acquisition) and in which the foreign ownership percentage is at least 60. This modification aligns the requirements for the third-country rule with the principles of section 7874.

The temporary regulations generally retain the domestic entity ownership and tax residency requirements as described in the 2015 notice. However, the temporary regulations clarify the application of the tax residency requirement by providing that the tax residency of the foreign acquiring corporation is determined after the covered foreign acquisition and all related transactions, and that the tax residency of the acquired foreign corporation is determined before the covered foreign acquisition and all related transactions.

### 5. Non-Ordinary Course Distributions (NOCD) Rule

#### a. Overview

The 2014 notice announced that the Treasury Department and the IRS intend to include in future regulations under section 7874 a rule (the NOCD rule) that disregards certain distributions made by a domestic entity before being acquired by a foreign acquiring corporation that otherwise would reduce the numerator of the ownership fraction. Specifically, section 2.02(b) of the 2014 notice provides that, for purposes of applying section 7874(c)(4), NOCDs made by the domestic entity (including a predecessor) during the 36-month period ending on the completion date will be treated as part of a plan a principal purpose of which is to avoid the purposes of section 7874.

The 2014 notice defines NOCDs as the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year. The 2014 notice defines distribution, in relevant part, to mean any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under section 355.

Section 4.02(b) of the 2015 notice provides that the future regulations incorporating the NOCD rule will include a de minimis exception. The 2015 notice provides that this exception, similar to the de minimis exception in § 1.7874–4T(d)(1), will apply to an acquisition that satisfies two requirements. First, the ownership percentage—determined without regard to § 1.7874–4T(b) (which disregards certain stock of the foreign acquiring corporation received in exchange for nonqualified property), the passive assets rule, and the NOCD rule—must be less than five (by vote and value). Second, after the domestic entity acquisition and all transactions related to the acquisition are complete, former domestic entity shareholders or former domestic entity partners, as applicable, of the domestic entity, in the aggregate, must own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) any member of the EAG.

The 2015 notice provides that, when a domestic entity acquisition satisfies the requirements of the de minimis exception, no distributions will be treated as NOCDs that are disregarded under the NOCD rule. The 2015 notice further provides, however, that even when a domestic entity acquisition satisfies the requirements of the de minimis exception, distributions that are part of a plan a principal purpose of which is to avoid the purposes of section 7874, determined without regard to the NOCD rule, will nevertheless be disregarded under section 7874(c)(4).

Further, the 2014 notice provides that § 1.367(a)–3(c) (concerning outbound transfers of stock or securities of a domestic corporation) will be modified to include a rule that incorporates the principles of the NOCD rule for purposes of the substantiality test, which, in general, requires that the value of the foreign acquiring corporation be equal to or greater than the value of the domestic target corporation.

b. Regulations implementing the NOCD rule

Section 1.7874–10T sets forth the NOCD rule as described in the 2014 notice and the 2015 notice, subject to certain modifications, in part, to address comments received. Section 1.367(a)–3T(c)(3)(iii)(C) sets forth a similar rule for purposes of the substantiality test under § 1.367(a)–3(c).

i. In General

Section 1.7874–10T(b) generally provides that, for purposes of determining the ownership percentage by value, former domestic entity shareholders or former domestic entity partners, as applicable, are deemed to receive, by reason of holding stock or an interest in the domestic entity, an amount of stock of the foreign acquiring corporation with a fair market value equal to the aggregate value of NOCDs made by the domestic entity (NOCD stock). Thus, similar to the rule under § 1.7874–2(h)(1) (regarding the treatment of options for purposes of determining the ownership percentage), the NOCD rule does not apply for purposes of determining the ownership percentage by vote. Similar to the rule addressing voting power in § 1.7874–2(h)(2), however, section 7874(c)(4) will nonetheless disregard distributions for purposes of determining the ownership percentage by vote that, without regard to the NOCD rule, are part of a plan a principal purpose of which is to avoid the purposes of section 7874.

The temporary regulations provide, consistent with the approach recommended in comments received, that the amount of a distribution (including with respect to property distributed in redemption of stock) is determined based on the value of the property distributed at the time of the distribution. See § 1.7874–10T(b). Accordingly, post-distribution fluctuations in the value of the stock or interests of the domestic entity, as applicable, or the value of the distributed property (for example, in the case of a spin-off), do not affect the amount of NOCD stock that is deemed received. A comment suggested additional guidance on valuing the stock of controlled corporations in spin-off transactions. The temporary regulations do not provide new guidance on this issue, which extends beyond the scope of the NOCD rule.

A comment generally recommended that, for purposes of determining the extent to which NOCD stock is deemed received, the NOCD rule should take into account the mix of stock and non-stock consideration provided by a foreign acquiring corporation. For example, if the foreign acquiring corporation acquires a domestic entity in exchange for 60 percent stock and 40 percent cash, the comment recommended that only 60 percent of the additional consideration deemed received under the NOCD rule would be treated as consisting of NOCD stock (with the remaining 40 percent of the additional consideration treated as consisting of cash and, to this extent, not increasing the ownership percentage). The same comment indicated that, under such an approach, additional guidance would be needed in certain cases in which a domestic entity had multiple classes of stock outstanding, particularly where the foreign acquiring corporation does not have a similar capital structure.

The NOCD rule is intended to address transactions in which a taxpayer elects to reduce its size by making distributions outside of the ordinary course to shareholders in order to reduce the amount of foreign acquiring stock that would have to be provided to such shareholders in a subsequent domestic entity acquisition. The Treasury Department and the IRS have determined that the mix of additional consideration that would have been provided in the subsequent domestic entity acquisition but for the NOCDs could differ from the mix of consideration that was actually provided in the domestic entity acquisition. This could occur, for example, due to limitations on the amount of cash that the foreign acquiring corporation was financially capable of providing. It is in fact this type of limitation that could motivate a domestic entity to make NOCDs in order to reduce the ownership percentage, rather than relying on cash consideration provided by the foreign acquiring corporation. In addition, the Treasury Department and the IRS have concluded that determining the hypothetical mix of consideration that would have been provided in the absence of NOCDs would give rise to significant administrative complexities. Accordingly, the temporary regulations do not adopt this comment, and, therefore, also do not provide guidance specific to cases where a domestic entity has, or had, multiple classes of stock outstanding.

A comment also requested clarification that the NOCD rule does not establish a safe harbor with respect to the application of section 7874(c)(4). Specifically, the comment requested clarification that, when a distribution is not disregarded under the NOCD rule, the distribution may nevertheless be disregarded under section 7874(c)(4) if, without regard to the NOCD rule, it was made with a principal purpose of avoiding the purposes of section 7874. The temporary regulations confirm that this is the case. See § 1.7874–10T(c). In addition, and also in response to a comment, the temporary regulations clarify that, when only a portion of a distribution is treated as an NOCD, the NOCD rule does not create a presumption that the remaining portion of the distribution was made with a principal purpose of avoiding the purposes of section 7874. See id. The remaining portion must be analyzed under section 7874(c)(4) in the same manner as any other distribution that is not treated as an NOCD.

Comments requested clarification regarding whether the NOCD rule could apply for purposes other than the ownership fraction. For example, the comments questioned whether property distributed as part of an NOCD could be considered held by the EAG for purposes of determining whether the EAG has substantial business activities in the relevant foreign country. The temporary regulations confirm that the NOCD rule applies only for purposes of determining the ownership percentage by value; it therefore does not apply for any other purpose, including, for example, the substantial business activities determination under § 1.7874–3 or the loss of control exception under § 1.7874–1(c)(3). Nevertheless, the scope of section 7874(c)(4), by its terms, is not limited to the ownership fraction and therefore may apply for other purposes under section 7874. See also, for example, § 1.7874–3(c), which provides anti-abuse rules pursuant to which certain items are not taken into account for purposes of the substantial business activities test, including items associated with properties or liabilities the transfer of which is disregarded under section 7874(c)(4).

ii. Scope of the NOCD Rule

Comments recommended narrowing the NOCD rule. For example, comments suggested that the NOCD rule should only create, either in all cases or at least with respect to section 355 distributions, a rebuttable presumption that a distribution identified as an NOCD under the rule is made with a principal purpose of avoiding the purposes of section 7874. Under this approach, if a taxpayer demonstrated that a distribution presumptively identified as an NOCD was not in fact made with a principal purpose of avoiding the purposes of section 7874, then the distribution would not be disregarded. A comment did note, though, that difficulties, uncertainties, and administrative burdens could arise under a rebuttable presumption approach. After considering the comments received, the Treasury Department and the IRS have determined that replacing the per se NOCD rule with a rebuttable presumption would give rise to significant uncertainty and administrative burden because the IRS would face significant challenges in ascertaining the purpose underlying each distribution. Accordingly, the temporary regulations do not adopt this approach.

A comment suggested that, if a nonrebuttable presumption is retained, the NOCD rule should be narrowed by other means, such as by (i) replacing the 36-month period during which distributions are subject to being disregarded under the NOCD rule with a 24-month period, (ii) increasing the 110% threshold, or (iii) excluding certain distributions (such as section 355 distributions, as well as certain other distributions) from the definition of distribution provided in the 2014 notice. This comment acknowledges that the adoption of many or all of these proposals, at the margins, could exempt certain tax-motivated distributions from the mechanical NOCD rules, but suggests that the IRS could nonetheless use its authority to disregard such distributions under the general anti-avoidance rule of section 7874(c)(4). After considering these comments, the Treasury Department and the IRS have concluded that these changes could inappropriately facilitate the use of distributions made with a principal purpose of avoiding the purposes of section 7874. For example, excluding section 355 distributions from the definition of distribution would undermine one of the purposes of the NOCD rule, which is to address certain section 355 distributions in which a domestic distributing corporation distributes one or more lines of business in order to facilitate a future inversion by either the controlled corporation or itself based on a business combination with a foreign corporation that may or may not have been definitively identified. Similarly, with respect to the 36-month period, a comment suggests that it is unlikely that a taxpayer would be able to determine 36 months before a particular transaction the amount of distributions that would be required to reduce the ownership percentage below 60% or 80% on the completion date. Large transactions, however, can take many months to close. Moreover, some companies that wish to pursue an inversion but have not yet definitively identified a foreign target may use NOCDs to reduce their size in order to expand the pool of appropriately-sized target companies. Accordingly, the Treasury Department and the IRS have determined that the parameters described in the 2014 notice and the 2015 notice strike the right balance between exempting non-abusive transactions from the NOCD rule and providing an administrable rule to address tax-motivated transactions. In particular, for the reasons described previously for not converting the NOCD rule into a rebuttable presumption, the Treasury Department and the IRS have concluded that the general anti-avoidance rule under section 7874(c)(4) would not be an effective backstop to looser objective tests. Accordingly, the temporary regulations do not adopt these recommendations.

Other comments suggested that the regulations should exclude the following distributions from the NOCD rule because they ordinarily would not give rise to avoidance concerns: (i) dividends or redemptions made pursuant to a policy that is carried out consistently for the 36-month period preceding the completion date; (ii) intercompany distributions by a controlled corporation to its corporate shareholder, before the latter distributes the former in a spin-off transaction; (iii) certain redemptions of preferred stock; and (iv) in the case of a domestic entity that is a domestic partnership, certain partnership distributions. These changes are not adopted in the temporary regulations because each type of distribution implicates the fundamental concern that it reduces the value of the domestic entity. Furthermore, the Treasury Department and the IRS have concluded that crafting an "angel list" of categories of distributions would make the NOCD rule more complex and in some cases could lead to inappropriate results. As an example of additional complexity, to produce symmetrical results, it would be necessary to distinguish these types of distributions from other distributions and exclude them not only from the look-back period, but also from the distribution history period (as described in Section iii of this Part I.B.5.b). Another comment suggested that aggregate distributions during a period be calculated by netting distributions against certain capital contributions. Although netting distributions against contributions could more accurately reflect any reduction in the value of the domestic entity, it would require additional rules to identify which contributions and distributions are appropriate to net, raising the same complexity concerns as the other comments. The Treasury Department and IRS also note that netting is not allowed in other settings, for example, in the excess distribution regime under section 1291 (which applies to passive foreign investment companies) and in § 1.7874–4T (which applies to domestic entity acquisitions). In particular, § 1.7874–4T does not allow for a foreign acquiring corporation to net the amount of disqualified stock, the issuance of which increases its value, against distributions it makes. In sum, the Treasury Department and the IRS have determined that the NOCD rule should operate as a bright-line rule, testing whether a domestic entity's value-decreasing distributions exceed a threshold amount. For this reason, and in response to a comment, the temporary regulations exclude from the definition of a distribution certain distributions described in sections 304 and 305 because they do not reduce the domestic entity's value. See § 1.7874–10T(h)(1)(i)(A) and (B).

iii. Determining NOCDs

The temporary regulations set forth five steps for determining the amount of NOCDs. The first step is to identify the look-back period, that is, the period during which distributions are subject to being disregarded under the NOCD rule. Under § 1.7874–10T(h)(4), the look-back period means the 36-month period ending on the completion date or, if shorter, the entire period starting with the formation date (described in § 1.7874–10T(h)(3) as the earliest of the dates that the domestic entity and any predecessor were created or organized) and ending on the completion date.

The next step is to divide the look-back period into look-back years. Although the 2014 notice contemplated using a taxable-year convention to determine a look-back year, a taxable-year convention may create undue complexity or uncertainty when—as noted in a comment—the completion date is not the last day of the domestic entity's taxable year, or when the domestic entity (or any predecessor) has a short taxable year. Because a 12-month convention more simply addresses these situations and thus provides for a more administrable NOCD rule, the Treasury Department and the IRS have determined that a 12-month convention should be used to determine a look-back year. Accordingly, the temporary regulations provide that a look-back year generally means any of the three consecutive 12-month periods that comprise the look-back period. See § 1.7874–10T(h)(5)(i). The temporary regulations also provide special rules for determining look-back years when the look-back period is less than 36 months. See § 1.7874–10T(h)(5)(ii) through (iv).

Once the look-back years have been determined, the distribution history period for each look-back year must be identified. The distribution history period for a look-back year generally means the 36-month period preceding the start of the look-back year. § 1.7874–10T(h)(2)(i). In response to a comment, the temporary regulations provide special rules for determining the distribution history period for a look-back year that is not preceded by 36 months of history. In particular, § 1.7874–10T(h)(2)(ii) provides that when the formation date is less than 36 months, but at least 12 months, before the start of a look-back year, then the distribution history period for that look-back year means the entire period, starting with the formation date, that precedes the start of the look-back year. Section 1.7874–10T(h)(2)(iii) provides that, when a look-back year is preceded by less than 12 months of history, then the look-back year is considered to not have a distribution history period.

Next, the NOCD threshold for each look-back year must be calculated. Except for a look-back year that does not have a distribution history period, the NOCD threshold for a look-back year means 110 percent of the sum of the distributions made during the distribution history period for that look-back year multiplied by a fraction. § 1.7874–10T(h)(7)(i). The numerator of the fraction is the number of days in the look-back year at issue, and the denominator of the fraction is the number of days in the distribution history period for that look-back year. Id. Thus, if a look-back year has a 36-month distribution history period, the NOCD threshold for that look-back year would be 110 percent of the distributions in the 36-month distribution history period, multiplied by 1/3 (simplified from 365/1095). Similarly, if a look-back year has only a 12-month distribution history period, then the NOCD threshold for that look-back year generally would be 110 percent of the distributions in the 12-month distribution history period, multiplied by 1 (simplified from 365/365). For a look-back year that does not have a distribution history period, the NOCD threshold is zero. § 1.7874–10T(h)(7)(ii).

The last step for determining the amount of NOCDs is to calculate, for each look-back year, the excess, if any, of all distributions made during the look-back year over the NOCD threshold for the look-back year. Under § 1.7874–10T(h)(6), the excess amounts constitute NOCDs.

One comment suggested an aggregate approach to determining NOCDs under which NOCDs would mean the excess of all distributions during the look-back period over 110 percent of the aggregate distributions made during the 36-month period preceding the look-back period. The approach described in the preceding paragraphs is generally consistent with the approach used in other areas of the Code. See, for example, sections 172(g)(3)(C) and 1291(b)(1). Moreover, for a domestic entity that has otherwise had a consistent distribution practice during the look-back period, the approach suggested by the comment would facilitate larger distributions than are intended to be permitted under the NOCD rule in the year preceding the domestic entity acquisition, the year in which abusive distributions are most likely. As a result, the Treasury Department and the IRS decline to adopt the recommendation.

iv. Predecessors

In response to a comment, the temporary regulations provide that a corporation or partnership (relevant entity) is treated for all purposes of the NOCD rule—including for purposes of look-back year calculations, distribution history period calculations, and NOCD threshold calculations—as having made distributions that were made by a predecessor of the relevant entity (the predecessor rule). § 1.7874–10T(e). Under the predecessor rule, a domestic entity "inherits" distributions made by a predecessor (and, such a predecessor could also be a relevant entity that inherits distributions made by a predecessor with respect to it).

(a) Purposes of the predecessor rule

The predecessor rule serves two purposes. First, the predecessor rule prevents potential avoidance of the NOCD rule. For example, absent the predecessor rule, a domestic corporation that would be treated as having NOCDs under the NOCD rule might, in anticipation of a domestic entity acquisition, undergo a reorganization into a newly formed domestic corporation and take the position that the newly formed domestic corporation has no distributions to which the NOCD rule applies. In addition, upon the combination of two domestic corporations in a transaction before a domestic entity acquisition, the domestic corporations might, absent the predecessor rule, structure the combination such that the corporation with the more favorable distribution history serves as the surviving corporation. Although section 7874(c)(4) could apply to address these types of transactions even absent the predecessor rule, the Treasury Department and the IRS have determined that it is appropriate to specifically address these transactions through the predecessor rule.

Second, the predecessor rule increases the accuracy of NOCD calculations. That is, when two entities combine in a transaction that increases the value of the combined group (for example, in a transaction in which a substantial portion of the consideration issued by the acquiring entity consists of equity interests in the entity), the distribution-paying capacity of the combined group increases. As a result, the separate distribution histories of the entities should be combined pursuant to the predecessor rule because, otherwise, post-combination distributions (which are funded by the earnings of both entities) might be compared to an NOCD threshold that is inappropriately low (that is, an NOCD threshold that takes into account the distribution history of only the acquiring entity).

(b) Definition of predecessor

In response to comments, the temporary regulations provide guidance on the meaning of predecessor. In particular, the temporary regulations provide that an entity (tentative predecessor) is a predecessor of another entity (relevant entity) when two requirements are satisfied. First, the relevant entity must complete a predecessor acquisition, which occurs when a relevant entity directly or indirectly acquires substantially all of the properties held directly or indirectly by the tentative predecessor. See § 1.7874–10T(f)(1)(i) and (f)(2)(i). Second, after the predecessor acquisition and all related transactions are complete, at least 10 percent of the stock (or interests) in the relevant entity must be held by reason of holding stock (or interests) in the tentative predecessor. See § 1.7874–10T(f)(1)(ii) and (f)(3).

The second requirement generally ensures that only transactions that result in a meaningful increase in the value of the relevant entity result in the predecessor's history being inherited by the relevant entity. The second requirement also generally ensures that, before the predecessor acquisition, the fair market value of the tentative predecessor is greater than a de minimis portion of the fair market value of the relevant entity. Accordingly, and in response to a comment, the second requirement generally prevents a tentative predecessor from being a predecessor in cases in which the utility of the relevant entity inheriting the historic distributions of the tentative predecessor could be outweighed by the potentially complicated due diligence required to determine those historic distributions. On the other hand, the Treasury Department and the IRS determined that it is not appropriate to condition predecessor status on a tentative predecessor being larger in value than the relevant entity at the time of the predecessor acquisition, as was suggested by a comment. Such a narrow definition of predecessor would not appropriately reflect the second, accuracy-related purpose of the predecessor rule, which requires taking into account the increase in the dividend-paying capacity of the combined entity.

(c) Distributions inherited by the domestic entity

Under the temporary regulations, when there is a predecessor of a relevant entity, the relevant entity inherits the full amount of any distributions made by the predecessor before the predecessor acquisition. § 1.7874–10T(e)(1). The relevant entity also inherits the full amount of any transfer of money or other property to the former owners of the predecessor that is made in connection with the predecessor acquisition, to the extent the money or other property was directly or indirectly provided by the predecessor. See § 1.7874–10T(e)(2); see also § 1.7874–10T(h)(1)(iv).

v. Domestic Entity Deemed to Have Distributed Stock of a Distributing Corporation in Certain Cases

A comment noted that, in cases in which a foreign corporation wishes to acquire only a portion of a domestic corporation's properties, different results may arise under the NOCD rule depending on how the parties structure the acquisition and related transactions. Consider, for example, a situation in which a domestic parent corporation (DP) owns two businesses, Business A ($600 fair market value) and Business B ($400 fair market value), and a foreign corporation (FA) wishes to acquire Business A in exchange for FA stock. Under one structure, DP could contribute Business B to a newly formed domestic corporation (DC) and then distribute the stock of DC to its shareholders, followed by FA acquiring all the stock of DP in exchange for $600 of FA stock. Under another structure, DP could contribute Business A to DC and then distribute the stock of DC to its shareholders, followed by FA acquiring all the stock of DC in exchange for $600 of FA stock. In the first scenario, because the $400 of value attributable to Business B was distributed by the domestic entity (DP), the NOCD rule would take into account the value of Business B. In the second scenario, however, the NOCD rule would not take into account the $400 of value of Business B, because the value of Business B was not distributed by the domestic entity (DC) and, moreover, DC would not inherit any portion of the distribution by DP of the DC stock. See § 1.7874–10T(f)(1) (defining a predecessor).

The comment explained that examples like the one in the preceding paragraph demonstrate that, if in certain cases the direction of a spin-off is respected for purposes of the NOCD rule, then transactions that are substantively the same could give rise to vastly different results under the NOCD rule depending on the direction of the spin-off. The comment noted that this could lead to abuse of the NOCD rule. The Treasury Department and the IRS agree with the concerns raised by the comment. As a result, the temporary regulations provide a special rule pursuant to section 7874(g) that, for purposes of the NOCD rule, creates parity between certain transactions regardless of the direction of a spin-off. See § 1.7874–10T(g).

The special rule in § 1.7874–10T(g) applies when a domestic corporation (domestic distributing corporation) distributes stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355 and, immediately before the distribution, the value of the distributed stock represents more than 50 percent of the value of the domestic distributing corporation. When the special rule applies, the controlled corporation is deemed for purposes of the NOCD rule to have distributed the stock of the distributing corporation. The value of the deemed distribution is equal to the fair market value of the distributing corporation (but not taking into account the fair market value of the stock of the controlled corporation) on the date of the distribution.

vi. NOCD Rule for Purposes of Section 367(a) Substantiality Test

The temporary regulations generally provide that, for purposes of the substantiality test in § 1.367(a)–3(c)(3)(iii)(A), the fair market value of the U.S. target company includes the aggregate value of NOCDs made by the U.S. target company. § 1.367(a)–3T(c)(3)(iii)(C). In this regard, NOCDs are calculated in the same manner as provided under § 1.7874–10T. See id. Thus, regardless of whether the transfer of stock of the U.S. target company is part of a domestic entity acquisition, the amount of NOCDs under § 1.367(a)–3T(c)(3)(iii)(C) is the same as the amount of NOCDs that would exist under § 1.7874–10T.

One comment recommended a de minimis exception should apply to the NOCD rule as applied for purposes of the section 367(a) substantiality test. The comment suggested that the exception could be based on a fixed dollar amount or percentage of the U.S. target company, perhaps conditioned on a requirement that the distribution not have been motivated by the substantiality test. The temporary regulations adopt the comment's recommendation to provide a de minimis exception, but do not adopt the comment's recommended formulation of the exception. Rather, because the Treasury Department and IRS have concluded that the NOCD rule should apply consistently under sections 367 and 7874, the temporary regulations provide that the NOCD rule under section 367 does not apply if the de minimis exception in § 1.7874–10T(d) would apply. See § 1.367(a)–3T(c)(3)(iii)(C).

C. *Subsequent transfers of stock of the foreign acquiring corporation and the EAG rules*

1. In General

In general, section 7874 is intended to apply to transactions in which a U.S. parent corporation of a multinational corporate group is replaced by a foreign parent corporation without a significant change in the ultimate ownership of the group. See H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess., at 568 (2004). Congress intended the statutory EAG rule in section 7874(c)(2)(A) to prevent section 7874 from applying to certain transactions that do not give rise to inversion policy concerns. For example, section 7874 should not apply to transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction, such as the conversion of a wholly-owned domestic subsidiary into a new wholly-owned CFC. See JCT Explanation, at 344. In this regard, section 7874(c)(2)(A) provides that stock of a foreign acquiring corporation that is held by members of the EAG is not included in the numerator or the denominator of the ownership fraction (statutory EAG rule).

The application of the statutory EAG rule may not always lead to appropriate results, including when the domestic entity has minority shareholders. To address these cases, § 1.7874–1 provides two exceptions to the statutory EAG rule: the internal group restructuring exception and the loss-of-control exception (together with the statutory EAG rule, the EAG rules). See § 1.7874–1(c)(2) and (3), respectively. When either of these exceptions applies, stock of the foreign acquiring corporation held by members of the

EAG is excluded from the numerator, but not the denominator, of the ownership fraction. In general, the internal group restructuring exception applies when the domestic entity and the foreign acquiring corporation are members of an affiliated group (generally based on an 80-percent vote-and-value requirement) with the same common parent both before and after the acquisition. The loss-of-control exception applies when the former domestic entity shareholders or former domestic entity partners do not hold more than 50 percent of the stock of any member of the EAG after the acquisition. For additional background on these exceptions, see the preamble to TD 9238, published on December 28, 2005, in the **Federal Register** (70 FR 76685).

Section 1.7874–5T addresses the effect on the numerator of the ownership fraction when former domestic entity shareholders or former domestic entity partners receive stock of the foreign acquiring corporation by reason of holding stock or a partnership interest in the domestic entity and then transfer that stock to another person. Specifically, § 1.7874–5T(a) provides that stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) shall not cease to be so described as a result of any subsequent transfer of the stock by the former domestic entity shareholder or former domestic entity partner that received the stock, even if the subsequent transfer is related to the domestic entity acquisition described in section 7874(a)(2)(B)(i). The preamble to that regulation notes that the Treasury Department and the IRS continue to study the extent to which subsequent transfers of stock of the foreign acquiring corporation should be taken into account in applying the EAG rules. See TD 9654, published on January 17, 2014, in the **Federal Register** (79 FR 3094, at 3099).

2. Rule Addressing Application of EAG Rules When There Is a Related Transfer of Stock of the Foreign Acquiring Corporation

Section 2.03(b) of the 2014 notice provides a rule concerning the interaction of § 1.7874–5T and the EAG rules. Subject to two exceptions, the 2014 notice provides that certain stock, referred to as "transferred stock," is not treated as held by a member of the EAG for purposes of applying the EAG rules. As a result, transferred stock generally is included in both the numerator and the denominator of the ownership fraction. See § 1.7874–5T(a). For this purpose, transferred stock is stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) that is received by a former domestic entity shareholder or former domestic entity partner that is a corporation (transferring corporation), and, in a transaction (or series of transactions) related to the domestic entity acquisition, is subsequently transferred.

The 2014 notice also described two exceptions to this rule: the U.S.-parented group exception and the foreign-parented group exception. When either of these exceptions applies, transferred stock is treated as held by members of the EAG for purposes of applying the EAG rules. In these cases, transferred stock is excluded from the numerator of the ownership fraction and, depending on the application of § 1.7874–1(c), may be excluded from the denominator of the ownership fraction. See § 1.7874–1(b) and (c).

The U.S.-parented group exception applies if: (i) before and after the domestic entity acquisition, the transferring corporation (or its successor) is a member of a U.S.-parented group, and (ii) after the domestic entity acquisition, both the person that holds the transferred stock after all related transfers of the transferred stock are complete and the foreign acquiring corporation are members of the U.S.-parented group referred to in (i).

The foreign-parented group exception applies if: (i) before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group, and (ii) after the domestic entity acquisition, the transferring corporation is a member of the EAG, or would be a member of the EAG absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the foreign-parented group in a transaction related to the domestic entity acquisition (but taking into account all other transactions related to such acquisition).

The 2014 notice defines a U.S.-parented group as an affiliated group that has a domestic corporation as the common parent corporation, and a foreign-parented group as an affiliated group that has a foreign corporation as the common parent corporation. For this purpose, the term "affiliated group" means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting the term "more than 50 percent" for the term "at least 80 percent" each place it appears. Finally, the 2014 notice provides that, except as provided in the foreign-parented group exception, all transactions related to the domestic entity acquisition must be taken into account for purposes of determining an EAG, a U.S.-parented group, and a foreign-parented group.

3. Regulations Implementing the Rule

Section 1.7874–6T sets forth the rule concerning the interaction of § 1.7874–5T and the EAG rules, as described in the 2014 notice, subject to the modifications described in this Part I.C.3, in part, to address comments received.

a. Loosening of the restrictions for the U.S.-parented group exception

In response to a comment, the Treasury Department and the IRS have determined that it is not necessary to limit the U.S.-parented group exception to cases in which the common parent after the domestic entity acquisition is the same as the common parent before the acquisition. Accordingly, under § 1.7874–6T, the U.S.-parented group exception applies if two requirements are satisfied. First, before the domestic entity acquisition, the transferring corporation must be a member of a U.S.-parented group. § 1.7874–6T(c)(1)(i). Second, after the domestic entity acquisition, each of the transferring corporation (or its successor), any person that holds transferred stock, and the foreign acquiring corporation must be members of a U.S.-parented group the common parent of which: (i) before the domestic entity acquisition, was a member (including the parent) of the U.S.-parented group described in the first requirement; or (ii) is a corporation that was formed in a transaction related to the domestic entity acquisition, provided that, immediately after the corporation was formed (and without regard to any related transactions), the corporation was a member of the U.S.-parented group described in the first requirement. § 1.7874–6T(c)(1)(ii).

A comment asserted that certain restructurings undertaken by foreign-parented groups could inappropriately be subject to section 7874. The comment posited a circumstance that is a variation of Example 2 of section 2.03(b)(iv) of the 2014 notice, where FA, the foreign acquiring corporation, acquired all the stock of a domestic corporation (DT) from a foreign corporation (FT) pursuant to a reorganization described in section 368(a)(1)(F). Related to the reorganization, FA subsequently issued shares to an individual in exchange for nonqualified property (as defined in § 1.7874–4T(i)(7)), which prevented FA and FT from being members of the same expanded affiliated group, therefore resulting in an ownership fraction of 100 percent. The comment asserted that there was no policy reason for section 7874 to apply to this transaction and requested that all "foreign-to-foreign" reorganizations described in section 368(a)(1)(F) be excluded from the application of section 7874.

The Treasury Department and the IRS decline to adopt the comment at this time. Section 1.7874–6T addresses the interaction of § 1.7874–5T and the EAG rules and, in particular, when transferred stock is treated as held by members of the EAG. In the example set forth in the comment, the stock that caused FA and FT to cease being members of the same EAG is not transferred stock. Thus, the comment is beyond the scope of the temporary regulations. Nevertheless, the Treasury Department and the IRS will continue to study the scope of section 7874 and its application to various transactions, including cases similar to the example set forth in the comment.

b. Identifying transferred stock

A comment noted that it is unclear how to identify transferred stock in certain cases. This may occur, for example, when a transferring corporation that receives stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) also holds other stock of the foreign acquiring corporation that has the same terms as the by-reason-of stock (other stock) (by-reason-of stock and other stock, collectively, fungible stock), and in a transaction related to the domestic entity acquisition, subsequently transfers less than all of the fungible stock. Different results would arise in these cases depending on the extent to which the subsequently transferred stock is considered to consist of by-reason-of stock or other stock.

To address this concern, the temporary regulations provide that a pro rata portion of the subsequently transferred stock is treated as consisting of by-reason-of stock. See § 1.7874–6T(f)(2)(ii).

c. Modifications to the affiliate-owned stock rules in § 1.7874–1

The temporary regulations modify the affiliate-owned stock rules in § 1.7874–1 to take into account the rules described in the 2014 notice. First, the temporary regulations provide that, subject to an exception, for purposes of §§ 1.7874–1 and 1.7874–1T, all transactions related to an acquisition are taken into account. See § 1.7874–1T(f). This rule is consistent with the general rule provided in § 1.7874–6T(e) and the general rule described in section 2.03(b)(i) of the 2014 notice.

Second, the temporary regulations modify the internal group restructuring exception to take into account § 1.7874–6T(c)(2). See § 1.7874–1T(c)(2)(iii).

D. *The substantial business activities test*

1. The Subject-to-Tax Rule

Section 2.02(a) of the 2015 notice provides a rule (the subject-to-tax rule) that addresses domestic entity acquisitions in which a taxpayer asserts that its EAG has substantial business activities in the relevant foreign country when compared to the EAG's total business activities even though the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country. Under the subject-to-tax rule, an EAG cannot have substantial business activities in the relevant foreign country when compared to the EAG's total business activities unless the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.

The temporary regulations implement the subject-to-tax rule described in the 2015 notice without making any substantive changes. See § 1.7874–3T(b)(4). The requirement set forth in § 1.7874–3T(b)(4) is in addition to the three quantitative tests for group employees, group assets, and group income set forth in § 1.7874–3(b)(1) through (3).

2. Clarification of "Group Income"

Under § 1.7874–3, an EAG is considered to have substantial business activities in the relevant foreign country only if at least 25 percent of its group employees, group assets, and group income are located or derived in the relevant foreign country. In general, group income is gross income from transactions occurring in the ordinary course of business with unrelated customers, as determined consistently under either federal tax principles or as reflected in the EAG's financial statements. With respect to group income determined using the EAG's financial statements, a comment in response to final regulations issued under § 1.7874–3 (see TD 9720, published on June 4, 2015, in the **Federal Register** (80 FR 31837)), questioned whether financial reporting principles apply only to determine the amount of items of income that is taken into account (such as where there is a book-tax difference) or also to determine which EAG members are to be taken into account during the testing period. The question arose because the regulations refer to the "International Financial Reporting Standards (IFRS) used for consolidated financial statement purposes." § 1.7874–3(d)(10). The reference in § 1.7874–3(d)(10) to the IFRS used for consolidated financial statement purposes is intended to ensure only that the EAG uses a single set of IFRS in preparing financial statements for this purpose, as there may be certain variations in the IFRS used in different countries. The temporary regulations clarify that financial reporting principles are only relevant for determining the amount of items of income that are taken into account, as an EAG must take into account all items that its members (as determined based on the definition of EAG set forth in § 1.7874–3(d)(4)) recognized for financial accounting purposes during the testing period.

II. *Rules Addressing Certain Post-Inversion Tax Avoidance Transactions*

As stated in Section 1 of the 2014 notice, the Treasury Department and the IRS understand that certain inversion transactions are motivated in substantial part by the ability to engage in tax avoidance transactions after the inversion transaction that would not be possible in the absence of the inversion transaction. In order to reduce the tax benefits of certain post-inversion tax avoidance transactions, the 2014 notice announced that the Treasury Department and the IRS would issue regulations under sections 304(b)(5)(B), 367, 956(e), 7701(l), and 7874 of the Code. Furthermore, the 2015 notice announced additional rules to reduce the tax benefits of certain post-inversion tax avoidance transactions.

A. *United States property rule*

1. Overview

As described in section 3.01(a) of the 2014 notice, an inversion transaction may permit the new foreign parent of the inverted group, a group still principally comprised of United States shareholders and their CFCs, to avoid section 956 by accessing the untaxed earnings and profits of the CFCs without a current U.S. federal income tax to the United States shareholders. This is a result that the United States shareholders could not achieve before the inversion transaction. The ability of the new foreign parent to access deferred CFC earnings and profits would in many cases eliminate the need for the CFCs to pay dividends to the United States shareholders, thereby circumventing the purposes of section 956.

In order to prevent this avoidance of section 956, section 3.01(b) of the 2014 notice announces that future regulations will include a rule (the United States property rule) providing that, solely for purposes of section 956, any obligation or stock of a non-CFC foreign related person (generally, either the foreign acquiring corporation or a foreign affiliate of the foreign acquiring corporation that is not an expatriated foreign subsidiary) is United States property within the meaning of section 956(c)(1) to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period. The 2014 notice defines an expatriated foreign subsidiary as a CFC with respect to which an expatriated entity is a United States shareholder, but provides that an expatriated foreign subsidiary does not include a CFC that is a member of the EAG on the completion date if the domestic entity is not a United States shareholder with respect to the CFC on or before the completion date. For example, a CFC owned by a U.S. corporation or U.S. partnership historically owned by the foreign parent generally would not be an expatriated foreign subsidiary because the domestic entity was not a United States shareholder with respect to such CFC on or before the completion date. See section 958(b)(4).

2. Regulations Implementing the United States Property Rule

These temporary regulations include the rules described in the 2014 notice, with certain modifications, in part, to address comments received.

a. General section 956 rule

Section 1.956–2T(a)(4)(i) provides that, generally, for purposes of section 956 and § 1.956–2(a), United States property includes an obligation of a foreign person and stock of a foreign corporation if (A) the obligation or stock is held by a CFC that is an expatriated foreign subsidiary, (B) the foreign person or foreign corporation is a non-CFC foreign related person, and (C) the obligation or stock was acquired either during the applicable period or in a transaction related to the inversion transaction. A non-CFC foreign related person is defined as a foreign related person that is not itself an expatriated foreign subsidiary. See § 1.7874–12T(a)(16). The rule applies to obligations and stock acquired during the applicable period or in a transaction related to the inversion transaction, regardless of whether at the time of acquisition the obligation or stock would constitute United States property—that is, regardless of whether, at the time of acquisition, the expatriated foreign subsidiary was a CFC or an expatriated foreign subsidiary, and the non-CFC foreign related person was a non-CFC foreign related person. Rather, the rules apply when the requirements set forth in § 1.956–2T(a)(4)(i) are satisfied on the expatriated foreign subsidiary's relevant quarterly measuring date.

The Treasury Department and the IRS have determined that CFC acquisitions of stock or obligations of a prospective foreign acquiring corporation or its foreign affiliates in contemplation of an inversion transaction present the same repatriation concerns as such acquisitions undertaken after an inversion transaction. Accordingly, § 1.956–2T(a)(4)(i)(C)(*2*) clarifies that stock or obligations that otherwise meet the requirements of the United States property rule described in the 2014 notice but that were issued prior to the applicable period, in a transaction related to the inversion transaction, constitute United States property, provided they are acquired on or after April 4, 2016.

An expatriated foreign subsidiary generally is defined as a CFC with respect to which an expatriated entity is a United States shareholder. See § 1.7874–12T(a)(9)(i). However, consistent with the 2014 notice, the Treasury Department and the IRS have determined that the CFCs of a domestic subsidiary owned by a foreign acquiring corporation before an inversion transaction should not be subject to the section 956 rules described in this Part II.A, or the rules under sections 7701(l) and 367(b) described in Sections B.1, B.2, and B.3 of this Part II. Accordingly, consistent with the 2014 notice, § 1.7874–12T(a)(9)(ii) excludes from the definition of expatriated foreign subsidiary a CFC that was a member of the EAG on the completion date if the domestic entity was not a United States shareholder with respect to the CFC on or before the completion date. As a result of not being treated as expatriated foreign subsidiaries, these CFCs are not subject to the new rules described in this Part II.A. However, the stock and obligations of these CFCs generally are United States property when acquired by an expatriated foreign subsidiary during the applicable period because these CFCs constitute non-CFC foreign related persons within the meaning of these temporary regulations. In addition, the exclusion from the definition of expatriated foreign subsidiary does not apply to CFCs of the foreign acquiring corporation's legacy domestic group that are formed or acquired after the inversion transaction. See § 1.956–2T(a)(4)(iv), *Example 4*.

The 2014 notice indicates that the term "expatriated entity" has the meaning provided in section 7874(a)(2)(A). Section 7874(a)(2)(A) defines an expatriated entity to include both the domestic entity and any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity. Comments questioned which entities are expatriated entities in certain cases, for example, when a domestic entity described in section 7874(a)(2)(B)(i) is transferred or ceases to exist. In response to these comments, these temporary regulations clarify that an expatriated entity means a domestic entity (which includes a successor to a domestic entity, whether domestic or foreign) and any United States person that, on any date on or after the completion date, is or was related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity. See § 1.7874–12T(a)(6) and (8). Thus, for example, an entity that is a domestic subsidiary of a foreign acquiring corporation on (and before) the completion date, is treated as an expatriated entity, while any CFCs owned by that domestic subsidiary on or before the completion date are not treated as expatriated foreign subsidiaries.

The 2014 notice also provides that an expatriated foreign subsidiary that is a pledgor or guarantor with respect to an obligation of a non-CFC foreign related person will be treated as holding the obligation, which would be United States property under the general rule of § 1.956–2T(a)(4)(i), to the same extent that it would be treated as holding the obligation if it were a pledgor or guarantor with respect to an obligation of a United States person under the principles of section 956(d) and § 1.956–2(c). Accordingly, these temporary regulations add § 1.956–2T(c)(5) to extend the pledge and guarantee rule in § 1.956–2(c) to apply to obligations of non-CFC foreign related persons. Under this rule, an expatriated foreign subsidiary that is (or is treated as) a pledgor or guarantor of an obligation of a non-CFC foreign related person is considered to hold the obligation for purposes of section 956. In addition to pledges or guarantees entered into or treated as entered into during the applicable period, the rule applies to pledges or guarantees entered into or treated as entered into in a transaction related to an inversion transaction provided they are entered into or treated as entered into on or after April 4, 2016.

b. Exceptions from United States property

In the description of the United States property rule in section 3.01(b) of the 2014 notice, the Treasury Department and the IRS requested comments on whether any exceptions under section 956(c)(2) or § 1.956–2 should apply to an obligation or stock of a non-CFC foreign related person that is United States property pursuant to the general rule in § 1.956–2T(a)(4)(i). A comment suggested that the following exceptions from United States property should apply to obligations of non-CFC foreign related persons: (i) the exception for obligations arising out of the sale or processing of property described in section 956(c)(2)(C); (ii) the exception for assets equal to the earnings of the CFC that have been taxed as effectively connected with the conduct of a U.S. trade or business included in section 956(c)(2)(H); (iii) the exception for certain deposits made in the ordinary course of a person's business as a dealer in securities or commodities described in section 956(c)(2)(I); and (iv) the exception in section 956(c)(2)(J) for obligations, to the extent the principal amount thereof does not exceed the fair market value of readily marketable securities sold or repurchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a person that is a securities or commodities dealer.

The Treasury Department and the IRS have concluded that it is appropriate for these exceptions to apply to obligations of non-CFC foreign related persons as well as United States persons because they relate to ordinary business transactions. The exceptions in section 956(c)(2)(H) and (I) apply by their terms to obligations of non-CFC foreign related persons, and thus no rules need to be added to the regulations to extend their application. On the other hand, the exceptions in current section 956(c)(2)(C) and (J) apply only to obligations of United States persons. Accordingly, these temporary regulations add rules in § 1.956–2T(a)(4)(ii)(A) and (B), pursuant to which obligations of non-CFC foreign related persons are excluded from the definition of United States property to the same extent that obligations of United States persons are excluded from the definition of United States property under section 956(c)(2)(C) and (J). In addition, new § 1.956–2T(d)(2)(iii) excludes from the definition of United States property obligations of non-CFC foreign related persons that arise in connection with the provision of services by a CFC, based on the principles of the exception in § 1.956–2T(d)(2)(ii) (previously § 1.956–2T(d)(2)(i)(B)), which sets forth a similar exclusion for obligations of United States persons.

A comment also advocated for an additional exception for CFCs that are regularly engaged in a third-party lending business. Specifically, the comment suggested that loans made by a CFC to related parties in the ordinary course of the CFC's business should not be treated as United States property when the CFC is regularly engaged in the business of making loans to unrelated parties. Alternatively, the comment suggested a more limited exclusion for loans made pursuant to a binding commitment that predated the inversion transaction, or negotiations leading to it, such as loans made under a revolving line of credit that was established several years before the first negotiations leading to the inversion transaction. An exception akin to the exception suggested by the comment does not currently exist with respect to obligations of United States persons. The consideration of new exceptions to the definition of United States property is beyond the scope of this regulation. Furthermore, the exception from the definition of non-CFC foreign related person for other expatriated foreign subsidiaries ensures that CFCs of a newly inverted group that are in the business of lending to other CFCs of the group will not be subject to section 956 with respect to the loans.

The 2014 notice provides that the exception to the definition of obligation for certain short-term obligations announced in Notice 88–108 (the short-term obligation exception) would not apply to obligations of non-CFC foreign related persons. As discussed in more detail in Part III.B of this Explanation of Provisions section, Notice 88–108 announced an exception for obligations that are collected within 30 days, as long as the CFC does not have loans to related United States persons that would constitute United States property outstanding during the year for 60 or more days. A comment requested that the Treasury Department and the IRS reconsider this position because the concerns underlying the exception exist with respect to foreign-parented groups as well as U.S.-parented groups, and questioned the rationale for eliminating this exception in the context of an inversion transaction. The Treasury Department and the IRS are concerned that there is a heightened risk that taxpayers would take abusive positions in reliance on the short-term obligation exception announced in Notice 88–108 in post-inversion transaction structures, due to the fact that gaining access to the deferred foreign earnings of CFCs without paying U.S. federal income tax is often a stated goal of inversion transactions. Accordingly, these temporary regulations provide that the exception announced in Notice 88–108 applies only to obligations of United States persons. Therefore, this exception does not apply to an obligation of a non-CFC foreign related person that is treated as United States property pursuant to § 1.956–2T(a)(4)(i).

### B. *Rules addressing avoidance of U.S. federal income tax on certain earnings and profits of a CFC or certain appreciation in a CFC's assets*

#### 1. Section 7701(l) Recharacterization Rule

##### a. Overview

As described in the 2014 notice, after an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a CFC using certain transactions that do not give rise to U.S. federal income tax, so as to avoid U.S. federal income tax on the CFC's pre-inversion transaction earnings and profits. Additionally, even if the foreign acquiring corporation were to acquire less stock of an expatriated foreign subsidiary, such that the expatriated foreign subsidiary remained a CFC, it could nevertheless substantially dilute a United States shareholder's ownership of the CFC. As a result, the United States shareholder could avoid U.S. federal income tax on the CFC's pre-inversion transaction earnings and profits if, for example, the CFC later redeemed, on a non pro rata basis, its stock held by the foreign acquiring corporation.

In order to prevent the use of these transactions to avoid U.S. federal income tax, the 2014 notice announces that the Treasury Department and the IRS intend to issue regulations under section 7701(l) that will recharacterize specified transactions completed during the applicable period (the section 7701(l) recharacterization rule). A specified transaction is defined in section 3.02(e)(i) of the 2014 notice as a transaction in which stock in an expatriated foreign subsidiary (specified stock) is transferred (including by issuance) to a specified related person. A specified related person means a non-CFC foreign related person, a U.S. partnership that has one or more partners that is a non-CFC foreign related person, or a U.S. trust that has one or more beneficiaries that is a non-CFC foreign related person.

Section 3.02(e)(i)(A) of the 2014 notice provides that a specified transaction is recharacterized for all purposes of the Code, as of the date on which the specified transaction occurs, as an arrangement directly between the specified related person and one or more section 958(a) U.S. shareholders of the expatriated foreign subsidiary. A section 958(a) U.S. shareholder of an expatriated foreign subsidiary is defined in the 2014 notice as a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock in the expatriated foreign subsidiary, but only if the United States shareholder is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person.

The 2014 notice states that regulations will provide that, if an expatriated foreign subsidiary issues specified stock to a specified related person, the specified transaction will be recharacterized as follows: (i) the property transferred by the specified related person to acquire the specified stock (transferred property) will be treated as having been transferred by the specified related person to the section 958(a) U.S. shareholder(s) of the expatriated foreign subsidiary in exchange for instruments deemed issued by the section 958(a) U.S. shareholder(s) (deemed instrument(s)); and (ii) the transferred property or proportionate share thereof will be treated as having been contributed by the section 958(a) U.S. shareholder(s) (through intervening entities, if any, in exchange for equity in such entities) to the expatriated foreign subsidiary in exchange for stock in the expatriated foreign subsidiary. The 2014 notice states that similar principles will apply to recharacterize a specified transaction in which a shareholder transfers specified stock of the expatriated foreign subsidiary to a specified related person (such as a partnership in which a non-CFC foreign related person is a partner).

Section 3.02(e)(i)(B) of the 2014 notice explains that regulations will provide that a deemed instrument treated as issued in a specified transaction will have the same terms as the specified stock (other than the issuer). Accordingly, if a distribution is made with respect to specified stock of the expatriated foreign subsidiary, matching seriatim distributions with respect to stock will be treated as made by the expatriated foreign subsidiary (through intervening entities, if any) to the section 958(a) U.S. shareholder(s). The section 958(a) U.S. shareholder(s), in turn, will be treated as making payments with respect to the deemed instrument(s) to the specified related person(s). An expatriated foreign subsidiary will be treated as the paying agent of a section 958(a) U.S. shareholder of the expatriated foreign subsidiary with respect to the deemed instrument treated as issued by the section

958(a) U.S. shareholder to a specified related person.

The 2014 notice states that the regulations will not recharacterize a specified transaction in certain situations. If the specified transaction is a fast-pay arrangement that is recharacterized under § 1.7701(l)–3(c)(2), section 3.02(e)(i)(A) of the 2014 notice provides that the rules of § 1.7701(l)–3 will apply instead of the recharacterization provided in the 2014 notice. Furthermore, section 3.02(e)(i)(C) of the 2014 notice provides that a specified transaction will not be recharacterized if the specified stock was transferred by a shareholder of the expatriated foreign subsidiary and, under applicable U.S. federal income tax rules, the shareholder either is required to recognize and include in income all of the gain in the specified stock (including gain treated as a deemed dividend pursuant to section 964(e) or 1248(a) or characterized as a dividend pursuant to section 356(a)(2)) or has a deemed dividend included in income with respect to the specified stock under § 1.367(b)–4 (including by reason of the regulations described in the 2014 notice that apply to specified exchanges, described in Section 2.c.i of this Part II.B). The last exception described in the 2014 notice applies if (i) the expatriated foreign subsidiary is a CFC immediately after the specified transaction and all related transactions, and (ii) the amount of stock (by value) in the expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) that is owned, in the aggregate, directly or indirectly by the section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction and any transactions related to the specified transaction does not decrease by more than 10 percent as a result of the specified transaction and any related transactions. The 2015 notice clarifies that the second prong of the exception is satisfied only if the percentage of stock (by value) (rather than the amount of stock (by value)) does not decrease by more than 10 percent.

Further, the 2014 notice states that regulations will provide that if a deemed dividend is included in a CFC's income under section 964(e) as a result of a specified transaction that is completed during the applicable period, the deemed dividend will not be excluded from foreign personal holding company income under section 954(c)(6) (to the extent in effect, and notwithstanding the rule described in Notice 2007–9, 2007–1 C.B. 401).

b. Regulations implementing the section 7701(l) recharacterization rule

These temporary regulations implement the section 7701(l) recharacterization rule described in the 2014 notice, subject to certain modifications, in part, to address comments received. Under § 1.7701(l)–4T(b)(1), a specified transaction completed during the applicable period will be recharacterized in the manner described in § 1.7701(l)–4T(c), subject to the exceptions described in § 1.7701(l)–4T(b)(2).

i. General Recharacterization Rule

The description of the specified transaction rules in section 3.02(e) of the 2014 notice provides that a "section 958(a) U.S. shareholder" means any United States shareholder of an expatriated foreign subsidiary that is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person. In order to more appropriately tailor the rules, these temporary regulations narrow the definition of the term "section 958(a) U.S. shareholder" to include only United States shareholders that are expatriated entities. See § 1.7701(l)–4T(f)(10).

If an expatriated foreign subsidiary issues specified stock to a specified related person, the specified transaction is recharacterized under § 1.7701(l)–4T(c)(2) in the manner described in the 2014 notice. Similar rules are provided in § 1.7701(l)–4T(c)(3) for a specified transaction arising from a transfer of specified stock by shareholders of the expatriated foreign subsidiary. In the 2014 notice, the Treasury Department and the IRS requested comments about the application of the recharacterization rules to transfers to partnerships that are specified related persons, as illustrated in Example 2 in section 3.02(e)(iii) of the notice. A comment suggested that the recharacterization described in the 2014 notice should not apply to transfers of specified stock to partnerships, and that, instead, a transferee partnership should be treated as a conduit, to the extent of its ownership of specified stock and any corresponding property contributed to the partnership. The comment suggested that the section 958(a) U.S. shareholder could be treated as directly owning the specified stock, or, alternatively, the items attributable to the specified stock could be tracked solely to the section 958(a) U.S. shareholder. Thus, under the proposed recast, each transferor to the partnership would be treated as retaining its economic interest in the property transferred to the partnership.

The Treasury Department and the IRS appreciate the complexity of the recharacterization described in the 2014 notice, as highlighted by the comment, but are concerned that the comment does not fully account for the treatment of distributions by the expatriated foreign subsidiary as received by its section 958(a) U.S. shareholder rather than the transferee partnership. After consideration of the comment's proposal, the Treasury Department and the IRS have determined that the recharacterization described in the 2014 notice better ensures that an expatriated foreign subsidiary that is transferred to a partnership that is a specified related person continues to be a CFC, while addressing the ancillary consequences of recharacterizing the transfer.

The expatriated foreign subsidiary stock that is deemed issued pursuant to the recharacterization is referred to in the regulations as "deemed issued stock," and the specified stock actually issued pursuant to the specified transaction but disregarded pursuant to the recharacterization is referred to as "disregarded specified stock." Because the instruments deemed issued by a section 958(a) U.S. shareholder have the same terms as the disregarded specified stock (other than the issuer), the Treasury Department and the IRS believe that the deemed instruments generally will be treated as equity for all purposes of the Code.

ii. Exceptions from Recharacterization

Section 1.7701(l)–4T(b)(2) sets forth three exceptions to the application of the rules in § 1.7701(l)–4T(c) to recharacterize a specified transaction. The first two exceptions are consistent with the exceptions described in the 2014 notice and the 2015 notice for fast-pay arrangements described in § 1.7701(l)–3(b) and transactions (including specified exchanges) in which an appropriate amount of gain is recognized. See Section 2.C of this Part II.B for a description of the rules applicable to specified exchanges.

The final exception applies when the expatriated foreign subsidiary is a CFC immediately after the specified transaction and any related transaction and there is only a de minimis shift of ownership of the stock of the expatriated foreign subsidiary or any lower-tier expatriated foreign subsidiary to non-CFC foreign related persons. See § 1.7701(l)–4T(b)(2)(iii). This exception (referred to in this Part II.B.1.b.ii as the "de minimis exception") replaces the exception described in the 2014 notice for specified transactions in which the ownership of section 958(a) U.S. shareholders did not decrease by more than 10 percent as a result of the specified transaction and any related transactions. The new de minimis exception better reflects the policy behind the section 7701(l) recharacterization rule by ensuring that dilution of the ownership interests of section 958(a) U.S. shareholders in an expatriated foreign subsidiary that is attributable to unrelated persons is not taken into account in determining whether the exception from recharacterization applies. See § 1.7701(l)–4T(g), *Example 3*.

The de minimis exception generally determines whether a specified transaction shifts ownership of stock of an expatriated foreign subsidiary (or any lower-tier expatriated foreign subsidiary) to non-CFC foreign related persons by comparing the percentage of the stock (by value) of the expatriated foreign subsidiary (or any lower-tier expatriated foreign subsidiary) owned immediately before and immediately after the transaction by persons other than non-CFC foreign related persons. For this purpose, to determine direct or indirect ownership, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or domestic. § 1.7701(l)–4T(f)(4). The de minimis exception applies if the post-transaction ownership percentage (defined in § 1.7701(l)–4T(f)(9)) is at least 90 percent of the pre-transaction ownership percentage (defined in § 1.7701(l)–4T(f)(8)).

The temporary regulations provide a special rule to ensure that stock of a corporation that is directly or indirectly owned by a domestic corporation that is an expatriated entity is considered for purposes of the de minimis exception as not owned by a non-CFC foreign related person. See § 1.7701(l)–4T(f)(4). Absent this special rule, such stock would not, to the extent such stock is indirectly owned by a non-CFC foreign related person through the domestic corporation, be treated as owned by a person other than a non-CFC foreign related person for purposes of the de minimis exception.

Because the de minimis exception measures the shift in ownership of lower-tier expatriated foreign subsidiaries as well as the expatriated foreign subsidiary whose stock is transferred or issued in the specified transaction, dilution of a United States person's indirect interest in a lower-tier expatriated foreign subsidiary can prevent the exception from applying, even if the United States person is not a section 958(a) U.S. shareholder with respect to that lower-tier expatriated foreign subsidiary. See § 1.7701(l)–4T(g), *Example 6*.

The 2014 notice requested comments on whether an exception to the section 7701(l) recharacterization rule and the section 367(b) stock dilution rule (described in Section 2 of this Part II.B) is warranted where (i) a specified transaction is undertaken in order to integrate similar or complementary businesses and (ii) after the inversion transaction, the inverted group in fact does not exploit that form in order to avoid U.S. taxation on the expatriated foreign subsidiary's pre-inversion earnings and profits. In addition, the 2014 notice requested comments on the provisions that would be necessary to administer such an exception and on the types of transactions that would need to serve as "triggers" for denying the exception because taxpayers could use them to avoid tax on a CFC's pre-inversion earnings after a specified transaction. One comment recommended providing a business integration exception because foreign-parented multinational groups of corporations often engage in internal restructurings for business reasons. After consideration of the comment, the Treasury Department and the IRS have determined that a business integration exception would be very difficult to administer given the subjective nature of the determination, the difficulty of determining whether the taxpayer takes "exploitative" actions in subsequent taxable years, and the complexity of potentially having to apply the section 7701(l) recharacterization rule retroactively depending on these subsequent actions. Accordingly, the temporary regulations do not provide a business integration exception.

iii. Transactions Affecting Ownership of Stock of an Expatriated Foreign Subsidiary Following a Recharacterized Specified Transaction

The rules in § 1.7701(l)–4T(d) address transactions that affect the ownership of stock of an expatriated foreign subsidiary after a specified transaction with respect to the expatriated foreign subsidiary has been recharacterized under § 1.7701(l)–4T(c)(2) or (3). As discussed in Section i of this Part II.B.1.b, a specified transaction that is recharacterized under the rules of § 1.7701(l)–4T(c) is recharacterized for all purposes of the Code as of the date that the specified transaction occurs. Although the recharacterization described in the 2014 notice generally applies for all purposes for all future tax years, the Treasury Department and the IRS considered whether to unwind the recharacterization when stock, including disregarded specified stock, in the expatriated foreign subsidiary is transferred (directly or indirectly) after the specified transaction, and considered adding other special rules concerning the results of a subsequent transfer of expatriated foreign subsidiary stock.

The specified transaction rules in § 1.7701(l)–4T are issued under the Secretary's regulatory authority in section 7701(l) to recharacterize multi-party financing arrangements to prevent the avoidance of tax, which is the same authority underlying the fast-pay arrangement rules in § 1.7701(l)–3. Although the two regulations serve a similar purpose, the technical rules that effectuate that purpose deviate due to differences in the underlying financing arrangements. The specified transaction rules set forth herein generally are concerned with the relationship of the expatriated foreign subsidiary to the expatriated entity, as well as the expatriated foreign subsidiary's status as a controlled foreign corporation, and thus generally are focused on abusive transactions that affect the direct and indirect ownership of the expatriated foreign subsidiary.

The 2014 notice states that rules similar to those described in § 1.7701(l)–3(c)(3)(iii) (concerning transfers of benefited stock) under the fast-pay regulations will apply to transactions affecting specified stock. In general, pursuant to § 1.7701(l)–3(c)(3)(iii)(A), the designation of stock as benefited stock continues upon transfer of the stock. Upon further consideration, the Treasury Department and the IRS have determined that it is not necessary for the specified transaction rules to maintain the connection between the instruments that are deemed issued pursuant to the recharacterization and the stock (specifically, the non-specified stock) that led to the application of the recharacterization rules, as occurs when § 1.7701(l)–3(c)(3)(iii) is applied to fast-pay stock, due to the differences in policy underlying the fast-pay regulations and these temporary regulations. Accordingly, a transfer of non-specified stock does not require an associated transfer of the deemed instruments as would be required under the rules in § 1.7701(l)–3(c)(3)(iii) for a transfer of benefited stock. See § 1.7701(l)–4T(d)(1).

However, the Treasury Department and the IRS determined that special rules are necessary to address direct and indirect transfers of stock of an expatriated foreign subsidiary (both disregarded specified stock and non-specified stock), including rules that generally terminate the recharacterization provided for in these temporary regulations. Transactions that occur after the specified transaction can affect the underlying ownership of the expatriated foreign subsidiary stock in such a way that the underlying need for the recharacterization rules ceases to exist. That is, there is no reason for the recharacterization rules to continue to apply when the reason for the rule ceases to apply; the rules need to apply only to the extent the relatedness that gave rise to the application of the rules continues to be present. In addition, transactions in which the inverted group no longer holds the expatriated foreign subsidiary create concerns about whether the taxpayer will have access to the information necessary to comply with the rules in these temporary regulations. In this circumstance, the administrative burden of maintaining the recharacterization is not justified.

Thus, the Treasury Department and the IRS have determined that it is appropriate, in certain circumstances, to unwind the recharacterization as a result of certain subsequent transactions that affect the ownership of the expatriated foreign subsidiary. The regulations provide that the recharacterization generally is fully unwound when an expatriated foreign subsidiary ceases to be a foreign related person. Specifically, § 1.7701(l)–4T(d)(2) provides that when a transaction causes an expatriated foreign subsidiary to cease to be a foreign related person, the recharacterization is fully unwound immediately before the transaction as follows: the section 958(a) U.S. shareholders are treated as redeeming their respective deemed instruments with the deemed issued stock in the expatriated foreign subsidiary, which, in turn, is "recapitalized" into the disregarded specified stock (which is the specified stock that was transferred in the specified transaction that gave rise to the application of § 1.7701–4T) in the hands of the specified related person.

In addition, the regulations provide for a similar pro-rata unwind when the expatriated foreign subsidiary continues to be a foreign related person after a direct or indirect transfer of disregarded specified stock of the expatriated foreign subsidiary, and, after the transfer, no portion of the disregarded specified stock is held by a foreign related person, a specified related person, or an expatriated entity. In such circumstances, § 1.7701(l)–4T(d)(3) provides that the recharacterization under § 1.7701(l)–4T(c)(2) or (3) is partially unwound as follows: the section 958(a) U.S. shareholders are treated as redeeming a proportionate amount of their respective deemed instruments with the deemed issued stock in the expatriated foreign subsidiary, which, in turn, is "recapitalized" into the disregarded specified stock (which is the specified stock that was transferred in the specified transaction that gave rise to the application of § 1.7701–4T) in the hands of the specified related person.

The regulations also provide a rule that applies when there is a direct transfer of disregarded specified stock, but the recharacterization is not unwound, because the transaction does not result in an unwind under the rules described earlier in this Part II.B.1.b.iii. In those circumstances, the transferor is treated as transferring the deemed instruments, in lieu of the disregarded specified stock, in exchange for the consideration that was received in exchange for the disregarded specified stock. See § 1.7701(l)–4T(d)(4).

Even if the rules described in this Part II.B.1.b.iii do not apply to unwind a recharacterization under the rules of § 1.7701(l)–4T(c)(2) or (3), an inverted group may choose to unwind the recharacterization by causing the expatriated foreign subsidiary to actually redeem all of its disregarded specified stock.

iv. Treatment of Deemed Dividends Included in Income under Section 964(e)

Under § 1.7701(l)–4T(e), and consistent with section 3.02(e)(i) of the 2014 notice, a deemed dividend that is included in a CFC's income under section 964(e) as a result of a specified transaction that is completed during the applicable period is not excluded from FPHCI under section 954(c)(6) (to the extent in effect and notwithstanding the rule described in Notice 2007–9). See Part III.C of this Explanation of Provisions section for a discussion of Notice 2007–9.

2. Section 367(b) Stock Dilution Rule

a. Overview

Section 3.02(e)(ii) of the 2014 notice provides a rule (the section 367(b) stock dilution rule) that addresses certain post-inversion transaction exchanges that dilute the interest of a United States shareholder in a CFC and, absent the rule, could allow the United States shareholder to avoid U.S. federal income tax on earnings and profits of the CFC that exist at the time of the exchange. Specifically, the section 367(b) stock dilution rule, as described in the 2014 notice, provides that when certain requirements are satisfied with respect to an exchange (see Section c.i of this Part II.B.2), the exchanging shareholder is generally required to include in income as a deemed dividend the section 1248 amount with respect to the stock exchanged.

As explained in the 2014 notice, the section 367(b) stock dilution rule is subject to an exception. The exception applies to exchanges that satisfy the principles of the second exception described in section 3.02(e)(i)(C) of the 2014 notice (regarding specified transactions that do not decrease, in the aggregate, the section 958(a) U.S. shareholders' ownership of stock in an expatriated foreign subsidiary (or lower-tier expatriated foreign subsidiary) by more than 10 percent).

The 2014 notice also provides that § 1.367(b)–4(c)(1) (regarding the exclusion of a deemed dividend from foreign personal holding company income) does not apply to a deemed dividend that results from an exchange to which the section 367(b) stock dilution rule applies. Further, the 2014 notice provides that such a deemed dividend does not qualify for the exceptions from foreign personal holding company income provided by section 954(c)(3)(A)(i) or (6) (to the extent in effect).

b. Application of the section 367(b) stock dilution rule to unrealized appreciation

The 2015 notice expands the consequences of being subject to the section 367(b) stock dilution rule. The 2015 notice provides that, when an exchanging shareholder is required under the section 367(b) stock dilution rule to include in income as a deemed dividend the section 1248 amount (if any) with respect to the stock exchanged, the exchanging shareholder must also, after taking into account any increase in basis provided in § 1.367(b)–2(e)(3)(ii) resulting from the deemed dividend, recognize all realized gain with respect to the stock that is not otherwise recognized. The 2015 notice explains that this result is necessary to prevent a United States shareholder of a CFC from potentially avoiding U.S. federal income tax on net unrealized built-in-gain in property held by the CFC at the time of the exchange of the stock of the CFC. See section 3.02(b) of the 2015 notice.

The 2015 notice also states that a conforming change will be made to the regulations described in section 3.02(e)(i) of the 2014 notice. Thus, as noted in Section 1.b.ii of this Part II.B, the first exception described in section 3.02(e)(i)(C) of the 2014 notice applies with respect to a transfer of specified stock only if, as a result of the transfer, all the gain in the specified stock is recognized.

c. Regulations implementing the section 367(b) stock dilution rule

The temporary regulations implement the section 367(b) stock dilution rule as described in the 2014 notice and the 2015 notice, subject to certain modifications. See § 1.367(b)–4T(e).

i. Requirements for the Section 367(b) Stock Dilution Rule to Apply

The section 367(b) stock dilution rule, as described in the 2014 notice, generally applies to an exchange when three requirements are satisfied. First, the exchanging shareholder must be described in § 1.367(b)–4(b)(1)(i)(A). Second, the exchange must occur pursuant to a transaction described in § 1.367(b)–4(a) in which the exchanging shareholder exchanges stock of an expatriated foreign subsidiary for stock in another foreign corporation. And third, the exchange must occur within the applicable period. The temporary regulations, as well as the remainder of this preamble, use the term "specified exchange" to describe any exchange that meets all three requirements and with respect to which the section 367(b) stock dilution rule thus generally applies. See § 1.367(b)–4T(e)(1) and (2).

ii. Exceptions to Section 367(b) Stock Dilution Rule

The Treasury Department and the IRS have determined that it is appropriate to provide two new exceptions to the section 367(b) stock dilution rule. The first exception applies to specified exchanges in which the exchanging shareholder is neither an expatriated entity nor an expatriated foreign subsidiary. The temporary regulations incorporate this exception into the first requirement for an exchange to be a specified exchange. See § 1.367(b)–4T(e)(2)(i) (requiring, among other things, that the exchanging shareholder be an expatriated entity or an expatriated foreign subsidiary).

The second exception replaces the exception described in the 2014 notice, and is consistent with the exception for de minimis shifts in ownership provided in § 1.7701(l)–4T(b)(2)(iii) and discussed in Section 1.b.ii of this Part II.B. Accordingly, the second exception applies to specified exchanges when the expatriated foreign subsidiary is a CFC immediately after the specified exchange and there is only a de minimis shift of ownership of the stock of the acquired expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) to non-CFC foreign related persons. See § 1.367(b)–4T(e)(3).

Under the second exception, as in the de minimis exception with respect to the section 7701(l) recharacterization rule provided in § 1.7701(l)–4T(b)(2)(iii), to determine whether a specified exchange shifts ownership of stock of an acquired expatriated foreign subsidiary (or any lower-tier expatriated foreign subsidiary) to non-CFC foreign related persons, the temporary regulations generally compare the percentage of the stock (by value) of the corporation owned immediately before and immediately after the exchange by persons other than non-CFC foreign related persons. In the case of asset acquisitions, however, because the acquired expatriated foreign subsidiary does not exist after the exchange, the temporary regulations compare (i) the percentage of the stock (by value) of the transferee foreign corporation—which may be viewed as a successor of the acquired expatriated foreign subsidiary for purposes of the exception—owned immediately after the exchange by persons other than non-CFC foreign related persons to (ii) the percentage of the stock (by value) of the acquired expatriated foreign subsidiary owned immediately before the exchange by persons other than non-CFC foreign related persons. The rules concerning the determination of indirect ownership for this purpose are identical to those applicable for purposes of the de minimis exception from the section 7701(l) recharacterization rule, described in Section 1.b.ii of this Part II.B.

Further, as is generally the case throughout § 1.367(b)–4, judicial doctrines and principles, such as substance-over-form and the step-transaction doctrine, apply in determining whether the requirements of a specified exchange or the de minimis exception are satisfied. See also Rev. Rul. 83–23, 1983–1 C.B. 82.

As noted in Section 1.b.ii of this Part II.B, the 2014 notice requested comments on whether an exception to the section 7701(l) recharacterization rule discussed therein and the section 367(b) stock dilution rule is warranted for certain business integration transactions. For the reasons discussed with respect to the section 7701(l) recharacterization rule, the temporary regulations do not provide a business integration exception with respect to the section 367(b) stock dilution rule.

iii. Treatment of Income Inclusions under Section 367(b)

Consistent with section 3.02(e)(ii) of the 2014 notice, § 1.367(b)–4T(e)(4) provides that an income inclusion of a foreign corporation under § 1.367(b)–4T(e)(1) does not qualify for the exceptions from foreign personal holding company income provided by sections 954(c)(3)(A)(i) and 954(c)(6) (to the extent in effect and notwithstanding the rule described in Notice 2007–9). See Part III.C of this Explanation of Provisions section for a discussion of Notice 2007–9.

3. Section 367(b) Asset Dilution Rule

a. Transactions at issue

For reasons similar to those discussed in section 3.02(d) of the 2014 notice and section 3.02(b) of the 2015 notice, the Treasury Department and the IRS have determined that, upon a transfer by an expatriated foreign subsidiary of property (other than stock of another expatriated foreign subsidiary) to a transferee foreign corporation in certain section 351 exchanges, the expatriated foreign subsidiary should be required to recognize all realized gain in the property that is not otherwise recognized. Absent such a rule, the transfer could dilute a United States shareholder's indirect interest in the property and, as a result, could allow the United States shareholder to avoid U.S. federal income tax on realized gain that is not recognized at the time of the transfer. For example, under section 351, an expatriated foreign subsidiary could transfer appreciated intangible property to a transferee foreign corporation in connection with a transfer by a non-CFC foreign related person to the transferee foreign corporation. Realized gain in the transferred property that is not recognized at the time of the transfer would, when recognized by the transferee foreign corporation after the transfer, create earnings and profits that are attributable to gain that economically had accrued within the U.S. federal income tax system at the time of the transfer. Because the United States shareholder would own less than all the stock of the transferee foreign corporation, the United States shareholder could avoid U.S. federal income tax on such earnings and profits, particularly if the transferee foreign corporation is not a CFC.

b. Regulations implementing the section 367(b) asset dilution rule

The temporary regulations provide a rule (the section 367(b) asset dilution rule) that applies when an expatriated foreign subsidiary transfers specified property to a foreign transferee corporation in an exchange described in section 351 that occurs within the applicable period. § 1.367(b)–4T(f)(1). When the section 367(b) asset dilution rule applies, the expatriated foreign subsidiary must recognize all realized gain (but not loss) with respect to the specified property that is not otherwise recognized, unless an exception applies. § 1.367(b)–4T(f)(1). For this purpose, specified property means any property other than stock of a lower-tier expatriated foreign subsidiary. § 1.367(b)–4T(g)(5).

Similar to the section 367(b) stock dilution rule, the section 367(b) asset dilution rule contains an exception that applies to transfers in which there is only a de minimis shift of ownership of the specified property to non-CFC foreign related persons. See § 1.367(b)–4T(f)(2). For purposes of the exception, the temporary regulations use ownership of stock of the expatriated foreign subsidiary immediately before the exchange as a proxy for ownership of specified property immediately before the exchange, and, similarly, use ownership of stock of the transferee foreign corporation immediately after the exchange as a proxy for ownership of specified property immediately after the exchange.

4. The Section 304 Rules

a. Transactions at issue

Section 3.03(b) of the 2014 notice explains how taxpayers may be engaging in certain transactions following an inversion transaction that reduce the earnings and profits of a CFC to facilitate repatriation of cash and other property of the CFC. The Treasury Department and the IRS understand that taxpayers may interpret section 304(b)(5)(B) to not apply when more than 50 percent of the dividend arising upon application of section 304 is sourced from the domestic corporation, even though, for example, pursuant to an income tax treaty there may be no (or a reduced rate of) U.S. withholding tax imposed on a dividend sourced from the domestic corporation. Under this position, the dividend sourced from earnings and profits of the CFC would never be subject to U.S. federal income tax.

b. Overview

To address the concerns described in Section a of this Part II.B.4, section 3.03(b) of the 2014 notice provides rules (the section 304 rules) that apply for purposes of section 304(b)(5)(B). In particular, the section 304 rules provide that the determination of whether more than 50 percent of the dividends that arise under section 304(b)(2) is subject to tax or includible in the earnings and profits of a CFC is made by taking into account only the earnings and profits of the acquiring corporation (and therefore excluding the earnings and profits of the issuing corporation). The section 304 rules also provide that if a partnership, option (or similar interest), or other arrangement, is used with a principal purpose of avoiding the application of the rule described in section 3.03(b) of the 2014 notice (for example, to treat a transferor as a CFC), then the partnership, option (or similar interest), or other arrangement will be disregarded for purposes of applying the rule. Further, the section 304 rules provide that these rules apply without regard to whether an inversion transaction has occurred.

c. Regulations implementing the section 304 rules

Section 1.304–7T sets forth regulations implementing the section 304 rules as described in the 2014 notice.

A comment requested that the regulations clarify that a dividend is "subject to tax" if it is reportable in the income of a U.S. person, even if that income is not currently burdened with tax because of the U.S. person's tax attributes. The Treasury Department and the IRS decline to adopt the comment at this time because the narrow scope of § 1.304–7T concerns taking into account only the earnings and profits of the acquiring corporation, for purposes of making the 50 percent determination discussed in Section b of this Part II.B.4.

C. *Inversion gain rule*

1. In General

Section 7874(a)(1), together with section 7874(e)(1) (which prevents the use of certain credits to offset U.S. federal income tax on inversion gain), ensures that an expatriated entity generally pays current U.S. federal income tax with respect to inversion gain. These rules are intended to ensure that an appropriate "toll charge" is paid on transactions that accompany or follow an inversion transaction and are designed to "remove income from foreign operations from the U.S. taxing jurisdiction." See H.R. Conf. Rep. No. 755, at 568, 574 (2004); JCT Explanation, at 342, 345.

Section 3.01(b) of the 2015 notice announces that the Treasury Department and the IRS intend to issue regulations that will provide a rule (the inversion gain rule) to address certain indirect transfers by an expatriated entity that, absent the rule, could have the effect of removing foreign earnings from the U.S. taxing jurisdiction while avoiding current U.S. federal income tax. As described in the 2015 notice, the inversion gain rule provides that inversion gain includes income or gain recognized by an expatriated entity from an indirect transfer or license of property, such as an expatriated entity's section 951(a)(1)(A) gross income inclusions taken into account during the applicable period that are attributable to a transfer of stock or other properties or a license of property, either: (i) as part of the acquisition, or (ii) after such acquisition if the transfer or license is to a specified related person. However, clause (ii) of the preceding sentence generally does not apply to transfers or licenses of property that is inventory in the hands of the transferor or licensor.

The inversion gain rule also provides that, if a partnership that is a foreign related person transfers or licenses property, a partner of the partnership is treated as having transferred or licensed its proportionate share of that property, as determined under the rules and principles of sections 701 through 777, for purposes of determining inversion gain.

2. Regulations Implementing the Inversion Gain Rule

Section 1.7874–11T sets forth the inversion gain rule as described in the 2015 notice, subject to the following modification. In response to a comment, § 1.7874–11T(b)(1) provides that inversion gain includes amounts treated as a dividend under section 78 with respect to foreign taxes deemed to be paid by an expatriated entity under section 902(a) or 960(a)(1).

III. *Miscellaneous Rules and Comment Request*

A. *New definitions section in section 7874 regulations*

As noted in Part I of the Background section of this preamble, the temporary regulations provide a new definitions section, § 1.7874–12T, that defines certain terms commonly used in §§ 1.367(b)–4T, 1.956–2T, 1.7701(l)–4T, 1.7874–2, 1.7874–2T, and 1.7874–6T through 1.7874–11T. The Treasury Department and the IRS anticipate, in the future, updating other portions of the section 7874 regulations to conform those sections with the nomenclature used in § 1.7874–12T.

A comment noted that certain rules in the 2014 notice apply to inversion transactions, defined as acquisitions in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2). The comment further noted that a transaction is not an inversion transaction if the substantial business activities requirement in section 7874(a)(2)(B)(iii) is not satisfied, but requested that this point be clarified in regulations.

The Treasury Department and the IRS believe that the definition of an inversion transaction, defined in the temporary regulations as a domestic entity acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), taking into account section 7874(a)(3), is clear. If the substantial business activities requirement in section 7874(a)(2)(B)(iii) is not satisfied, the foreign acquiring corporation is not a surrogate foreign corporation, and the acquisition therefore is not an inversion transaction. Accordingly, this comment is not adopted.

B. *Rules under section 956 relating to the definition of obligation announced in Notice 88–108, Notice 2008–91, Notice 2009–10, and Notice 2010–12*

On September 16, 1988, the Treasury Department and the IRS issued Notice 88–108, which announced that regulations would be issued under section 956 that would exclude from the definition of the term "obligation" for purposes of section 956 obligations that are collected within 30 days, as long as the CFC does not have loans to related United States persons that would constitute United States property outstanding during the year for 60 or more days (the 30/60 day exception). Due to circumstances affecting liquidity in the United States during 2008, on October 4, 2008, the Treasury Department and the IRS issued Notice 2008–91, which announced that the 30/60 day exception would be expanded to exclude obligations that are collected within 60 days, as long as the CFC does not have loans outstanding to related United States persons that would constitute United States property during the year for 180 or more days (the 60/180 day exception). A

CFC could choose to apply either the 30/60 day exception or the 60/180 day exception in years in which the 60/180 day exception is applicable. Notice 2008–91 applies for the first two taxable years of a foreign corporation ending after October 3, 2008, but does not apply to taxable years of a foreign corporation beginning after December 31, 2009. On January 14, 2009, the Treasury Department and the IRS issued Notice 2009–10, which extends the application of the regulations described in Notice 2008–91 to a third taxable year in certain cases. On December 28, 2009, the Treasury Department and the IRS issued Notice 2010–12, which extends the application of Notice 2008–91 to the taxable year of the CFC that immediately follows the last taxable year of the CFC to which the regulations described in Notice 2008–91 otherwise could apply.

These temporary regulations set forth the exceptions to the definition of obligation that were announced in Notice 88–108 and Notice 2008–91, as modified by Notice 2009–10 and Notice 2010–12. Section 1.956–2T(d)(2)(iv) provides the short-term obligation exception described in Notice 88–108, and § 1.956–2T(d)(2)(v) provides the alternative short-term obligation exception described in Notice 2008–91, Notice 2009–10 and Notice 2010–12. For the years in which § 1.956–2T(d)(2)(v) is applicable, CFCs can choose to apply either paragraph (iv) or paragraph (v) of § 1.956–2T(d)(2).

As noted in Part II.A.2.b of this Explanation of Provisions section, the exceptions in § 1.956–2T(d)(2)(iv) and (v) apply only to obligations of United States persons, and thus do not apply to an obligation of a non-CFC foreign related person that is treated as United States property pursuant to § 1.956–2T(a)(4)(i).

The rules in § 1.956–2T(d)(2)(iv) described in this Part III.B that were described in Notice 88–108 apply to obligations held on or after September 16, 1988, and the rules in § 1.956–2T(d)(2)(v) apply to the first three taxable years of a foreign corporation ending after October 3, 2008, other than taxable years of a foreign corporation beginning on or after January 1, 2011, as well as the fourth taxable year of a foreign corporation, if any, when the foreign corporation's third taxable year (including any short taxable year) ended after October 3, 2008, and on or before December 31, 2009.

C. *Request for comments with respect to rules under section 954(c)(6) announced in Notice 2007–9 affected by the 2014 notice*

On January 11, 2007, the Treasury Department and the IRS issued Notice 2007–9, which provided guidance under section 954(c)(6) and announced that regulations under section 954(c)(6) that incorporated the guidance provided in the notice would be issued. In particular, Notice 2007–9 announced that gains treated as dividends under section 964(e) would be included among dividends eligible for the exclusion from FPHCI in section 954(c)(6). In the 2014 notice, the Treasury Department and the IRS announced that, notwithstanding Notice 2007–9, a deemed dividend included in a CFC's income under section 964(e) as a result of a specified exchange or a specified transaction that is completed during the applicable period would not be excluded from FPHCI under section 954(c)(6). As noted in Parts II.B.1.b.iv and II.B.2.c.iii of this Explanation of Provisions section, §§ 1.367(b)–4T(e)(4) and 1.7701(l)–4T(e) set forth the limitations on the applicability of section 954(c)(6) described in the 2014 notice. The Treasury Department and the IRS request comments as to whether it is appropriate to treat other amounts included by a CFC in gross income as a dividend under section 964(e) as dividends from a related person to which section 954(c)(6) may apply.

**Effect on Other Documents**

Notice 88–108, 1988–2 C.B. 446 is obsolete as of April 4, 2016.

Notice 2008–91, 2008–43 I.R.B. 1001 is obsolete as of April 4, 2016

Notice 2009–10, 2009–5 I.R.B. 419 is obsolete as of April 4, 2016.

Notice 2010–12, 2010–4 I.R.B. 326 is obsolete as of April 4, 2016.

Notice 2014–52, 2014–42 I.R.B. 712 is obsolete as of April 4, 2016.

Notice 2015–79, 2015–49 I.R.B. 775 is obsolete as of April 4, 2016.

**Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

**Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It has been determined that sections 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) do not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the cross-referenced notice of proposed rulemaking published elsewhere in the 2016–18 issue of the **Bulletin**. Pursuant to section 7805(f) of the Internal Revenue 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.

**Drafting Information**

The principal authors of these regulations are Rose E. Jenkins, David A. Levine, and Shane M. McCarrick of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

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**Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for § 1.367(b)–4T and adding the following entries in numerical order to read in part as follows:

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

Section 1.304–7T also issued under 26 U.S.C. 304(b)(5)(C).

* * * * *

Section 1.367(b)–4T also issued under 26 U.S.C. 367(b) and 954(c)(6)(A).

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Section 1.956–2T also issued under 26 U.S.C. 956(d) and 956(e).

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Section 1.7701(l)–4T also issued under 26 U.S.C. 7701(l) and 954(c)(6)(A).

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Section 1.7874–2T also issued under 26 U.S.C. 7874(c)(6) and (g).

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Section 1.7874–3T also issued under 26 U.S.C. 7874(c)(6) and (g).

* * * * *

Section 1.7874–6T also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–7T also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–8T also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–9T also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–10T also issued under 26 U.S.C. 7874(c)(4) and (g).

Section 1.7874–11T also issued under 26 U.S.C. 7874(g).

Section 1.7874–12T also issued under 26 U.S.C. 7874(g).

Par. 2. Section 1.304–6 is added to read as follows:

*§ 1.304–6 Amount constituting a dividend*. [Reserved]

Par. 3. Section 1.304–7T is added to read as follows:

*§ 1.304–7T Certain acquisitions by foreign acquiring corporations (temporary).*

(a) *Scope*. This section provides rules regarding the application of section 304(b)(5)(B) to an acquisition of stock described in section 304 by an acquiring corporation that is foreign (foreign acquiring corporation). Paragraph (b) of this section provides the rule for determining which earnings and profits are taken into account for purposes of applying section 304(b)(5)(B). Paragraph (c) of this section provides rules addressing the use of a partnership, option (or similar interest), or other arrangement. Paragraph (d) of this section provides examples that illustrate the rules of this section. Paragraph (e) of this section provides the applicability date, and paragraph (f) of this section provides the date of expiration.

(b) *Earnings and profits taken into account*. For purposes of applying section 304(b)(5)(B), only the earnings and profits of the foreign acquiring corporation are taken into account in determining whether more than 50 percent of the dividends arising from the acquisition (determined without regard to section 304(b)(5)(B)) would neither be subject to tax under chapter 1 of subtitle A of the Internal Revenue Code for the taxable year in which the dividends arise (subject to tax) nor be includible in the earnings and profits of a controlled foreign corporation, as defined in section 957 and without regard to section 953(c) (includible by a controlled foreign corporation).

(c) *Use of a partnership, option (or similar interest), or other arrangement*. If a partnership, option (or similar interest), or other arrangement, is used with a principal purpose of avoiding the application of this section (for example, to treat a transferor as a controlled foreign corporation), then the partnership, option (or similar interest), or other arrangement will be disregarded for purposes of applying this section.

(d) *Examples*. The following examples illustrate the rules of this section. For purposes of the examples, assume the following facts in addition to the facts stated in the examples:

(1) FA is a foreign corporation that is not a controlled foreign corporation;

(2) FA wholly owns DT, a domestic corporation;

(3) DT wholly owns FS1, a controlled foreign corporation; and

(4) No portion of a dividend from FS1 would be treated as from sources within the United States under section 861.

*Example 1*—(i) *Facts*. DT has earnings and profits of $51x, and FS1 has earnings and profits of $49x. FA transfers DT stock with a fair market value of $100x to FS1 in exchange for $100x of cash.

(ii) *Analysis*. Under section 304(a)(2), the $100x of cash is treated as a distribution in redemption of the stock of DT. The redemption of the DT stock is treated as a distribution to which section 301 applies pursuant to section 302(d), which ordinarily would be sourced first from FS1 under section 304(b)(2)(A). Without regard to the application of section 304(b)(5)(B), more than 50 percent of the dividend arising from the acquisition, taking into account only the earnings and profits of FS1 pursuant to paragraph (b) of this section, would neither be subject to tax nor includible by a controlled foreign corporation. In particular, no portion of a dividend from FS1 would be subject to tax or includible by a controlled foreign corporation. Accordingly, section 304(b)(5)(B) and paragraph (b) of this section apply to the transaction, and no portion of the distribution of $100x is treated under section 301(c)(1) as a dividend out of the earnings and profits of FS1. Furthermore, the $100x of cash is treated as a dividend to the extent of the earnings and profits of DT ($51x).

*Example 2*—(i) *Facts*. FA and DT own 40 percent and 60 percent, respectively, of the capital and profits interests of PRS, a foreign partnership. PRS wholly owns FS2, a controlled foreign corporation. The FS2 stock has a fair market value of $100x. FS1 has earnings and profits of $150x. PRS transfers all of its FS2 stock to FS1 in exchange for $100x of cash. DT enters into a gain recognition agreement that complies with the requirements set forth in section 4.01 of Notice 2012–15, 2012–9 I.R.B 424, with respect to the portion (60 percent) of the FS2 stock that DT is deemed to transfer to FS1 in an exchange described in section 367(a)(1). See § 1.367(a)–1T(c)(3)(i)(A).

(ii) *Analysis*. Under section 304(a)(1), PRS and FS1 are treated as if PRS transferred its FS2 stock to FS1 in an exchange described in section 351(a) solely for FS1 stock, and, in turn, FS1 redeemed such FS1 stock in exchange for $100x of cash. The redemption of the FS1 stock is treated as a distribution to which section 301 applies pursuant to section 302(d). Without regard to the application of section 304(b)(5)(B), more than 50 percent of a dividend arising from the acquisition, taking into account only the earnings and profits of FS1 pursuant to paragraph (b) of this section, would be subject to tax. In particular, 60 percent of a dividend from FS1 would be included in DT's distributive share of PRS's partnership income and therefore would be subject to tax. Accordingly, section 304(b)(5)(B) does not apply, and the entire distribution of $100x is treated under section 301(c)(1) as a dividend out of the earnings and profits of FS1.

(e) *Applicability date*. This section applies to acquisitions that are completed on or after September 22, 2014.

(f) *Expiration date*. This section expires on April 4, 2019.

Par. 4. Section 1.367(a)–3 is amended by:

1. Revising the paragraph heading of paragraph (c)(3)(iii)(B).
2. Adding paragraph (c)(3)(iii)(C).
3. Redesignating paragraph (c)(11) as paragraph (c)(11)(i).
4. Adding a paragraph heading for paragraph (c)(11) and revising the paragraph heading of newly redesignated paragraph (c)(11)(i).

5. Revising the first sentence of newly redesignated paragraph (c)(11)(i).
6. Adding paragraph (c)(11)(ii).

The additions and revisions read as follows:

*§ 1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.*

* * * * *

(c) * * *

(3) * * *

(iii) * * *

(B) *Special rules for transferee foreign corporation value.** * *

* * * * *

(C) [Reserved]. For further guidance, see § 1.367(a)–3T(c)(3)(iii)(C).

* * * * *

(11) *Applicability date of this paragraph (c)*—(i) *In general*. Except as otherwise provided, this paragraph (c) applies to transfers occurring after January 29, 1997. * * *

(ii) [Reserved]. For further guidance, see § 1.367(a)–3T(c)(11)(ii).

* * * * *

Par. 5. Section 1.367(a)–3T is added to read as follows:

*§ 1.367(a)–3T Treatment of transfers of stock or securities to foreign corporations. (temporary).*

(a) through (c)(3)(iii)(B) [Reserved]. For further guidance, see § 1.367(a)–3(a) through (c)(3)(iii)(B).

(C) *Special rule for U.S. target company value*. For purposes of § 1.367(a)–3(c)(3)(iii)(A), the fair market value of the U.S. target company includes the aggregate amount of non-ordinary course distributions (NOCDs) made by the U.S. target company. To calculate the aggregate value of NOCDs, the principles of § 1.7874–10T, including the rule regarding predecessors in § 1.7874–10T(e) and the rule regarding a deemed distribution of stock in certain cases in § 1.7874–10T(g), apply. However, this paragraph (c)(3)(iii)(C) does not apply if the principles of the de minimis exception in § 1.7874–10T(d) are satisfied.

(4) through (11)(i) [Reserved]. For further guidance, see § 1.367(a)–3(c)(4) through (c)(11)(i).

(ii) *Applicability date of certain provisions of this paragraph (c)*. The first and second sentence of paragraph (c)(3)(iii)(C) of this section apply to transfers completed on or after September 22, 2014. The third sentence of paragraph (c)(3)(iii)(C) of this section applies to transfers completed on or after November 19, 2015. Taxpayers may, however, elect to apply the third sentence of paragraph (c)(3)(iii)(C) of this section to transfers completed on or after September 22, 2014, and before November 19, 2015.

(d) through (j) [Reserved]. For further guidance, see § 1.367(a)–3(d) through (j).

(k) *Expiration date*. Paragraph (c)(3)(iii)(C) of this section expires on April 4, 2019.

Par. 6. Section 1.367(b)–4 is amended by:

1. Revising paragraph (a).
2. Revising the introductory text of paragraph (b).
3. In paragraph (b)(1)(i)(A)(*2*), removing the word "and" at the end of the paragraph.
4. In paragraph (b)(1)(i)(B)(*2*), removing the period at the end of the paragraph and adding "; and" in its place.
5. Adding paragraph (b)(1)(i)(C).
6. Revising paragraph (d)(1).
7. Adding paragraph (h).

The additions and revisions read as follows:

*§ 1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.*

(a) [Reserved]. For further guidance, see § 1.367(b)–4T(a).

(b) introductory text [Reserved]. For further guidance, see § 1.367(b)–4T(b) introductory text.

(1) * * *

(i) * * *

(C) [Reserved]. For further guidance, see § 1.367(b)–4T(b)(1)(i)(C).

* * * * *

(d) * * *

(1) [Reserved]. For further guidance, see § 1.367(b)–4T(d)(1).

* * * * *

(h) [Reserved]. For further guidance, see § 1.367(b)–4T(h).

Par. 7. Section 1.367(b)–4T is revised to read as follows:

*§ 1.367(b)–4T Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions (temporary).*

(a) *Scope*. This section applies to certain acquisitions by a foreign corporation of the stock or assets of a foreign corporation in an exchange described in section 351 or in a reorganization described in section 368(a)(1). Paragraph (b) of this section provides a rule regarding when an exchanging shareholder is required to include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges. Paragraph (c) of this section provides a rule excluding deemed dividends from foreign personal holding company income. Paragraph (d) of this section provides rules for subsequent sales or exchanges. Paragraphs (e) and (f) of this section provide rules regarding certain exchanges following inversion transactions. Paragraph (g) of this section provides definitions and special rules, including special rules regarding triangular reorganizations and recapitalizations. Paragraph (h) of this section provides the applicability dates, and paragraph (i) of this section provides the date of expiration. See also § 1.367(a)–3(b)(2) for transactions subject to the concurrent application of sections 367(a) and (b) and § 1.367(b)–2 for additional definitions that apply.

(b) *Income inclusion*. If a foreign corporation (the transferee foreign corporation) acquires the stock of a foreign corporation in an exchange described in section 351 or the stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), then an exchanging shareholder must, if its exchange is described in paragraph (b)(1)(i), (b)(2)(i), or (b)(3) of this section, include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

(b)(1) through (b)(1)(i)(B) [Reserved]. For further guidance, see § 1.367(b)–4(b)(1) through (b)(1)(i)(B).

(C) The exchange is not a specified exchange to which paragraph (e)(1) of this section applies.

(b)(1)(ii) through (d) introductory text [Reserved]. For further guidance, see

§ 1.367(b)–4(b)(1)(ii) through (d) introductory text.

(1) *Rule*. If an exchanging shareholder (as defined in § 1.1248–8(b)(1)(iv)) is not required to include in income as a deemed dividend the section 1248 amount under § 1.367(b)–4(b) or paragraph (e)(1) of this section (non-inclusion exchange), then, for purposes of applying section 367(b) or 1248 to subsequent sales or exchanges, and subject to the limitation of § 1.367(b)–2(d)(3)(ii) (in the case of a transaction described in § 1.367(b)–3), the determination of the earnings and profits attributable to the stock an exchanging shareholder receives in the non-inclusion exchange is determined pursuant to the rules of section 1248 and the regulations under that section.

(2) [Reserved]. For further guidance, see § 1.367(b)–4(d)(2).

(e) *Income inclusion and gain recognition in certain exchanges following an inversion transaction*—(1) *General rule*. If a foreign corporation (the transferee foreign corporation) acquires stock of a foreign corporation in an exchange described in section 351 or stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), then an exchanging shareholder must, if its exchange is a specified exchange and the exception in paragraph (e)(3) of this section does not apply—

(i) Include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges; and

(ii) After taking into account the increase in basis provided in § 1.367(b)–2(e)(3)(ii) resulting from the deemed dividend (if any), recognize all realized gain with respect to the stock that would not otherwise be recognized.

(2) *Specified exchanges*. An exchange is a specified exchange if—

(i) Immediately before the exchange, the foreign acquired corporation is an expatriated foreign subsidiary and the exchanging shareholder is either an expatriated entity described in § 1.367(b)–4(b)(1)(i)(A)(*1*) or an expatriated foreign subsidiary described in § 1.367(b)–4(b)(1)(i)(A)(*2*);

(ii) The stock received in the exchange is stock of a foreign corporation; and

(iii) The exchange occurs during the applicable period.

(3) *De minimis exception*. The exception in this paragraph (e)(3) applies if—

(i) Immediately after the exchange, the foreign acquired corporation (in the case of an acquisition of stock of the foreign acquired corporation) or the transferee foreign corporation (in the case of an acquisition of assets of the foreign acquired corporation) is a controlled foreign corporation;

(ii) The post-exchange ownership percentage with respect to the foreign acquired corporation (in the case of an acquisition of stock of the foreign acquired corporation) or the transferee foreign corporation (in the case of an acquisition of assets of the foreign acquired corporation) is at least 90 percent of the pre-exchange ownership percentage with respect to the foreign acquired corporation; and

(iii) The post-exchange ownership percentage with respect to each lower-tier expatriated foreign subsidiary of the foreign acquired corporation is at least 90 percent of the pre-exchange ownership percentage with respect to the lower-tier expatriated foreign subsidiary.

(4) *Certain exceptions from foreign personal holding company not available*. An income inclusion of a foreign corporation under paragraph (e)(1) of this section does not qualify for the exceptions from foreign personal holding company income provided by sections 954(c)(3)(A)(i) and 954(c)(6) (to the extent in effect).

(5) *Examples*. The following examples illustrate the application of this paragraph (e). For purposes of all of the examples, unless otherwise indicated: FP, a foreign corporation, owns all of the stock of USP, a domestic corporation, and all 40 shares of stock of FS, a foreign corporation. USP owns all 50 shares of stock of FT1, a controlled foreign corporation, which, in turn, owns all 50 shares of FT2, a controlled foreign corporation. FP acquired all of the stock of USP in an inversion transaction that was completed on July 1, 2016. Therefore, with respect to that inversion transaction, USP is an expatriated entity; FT1 and FT2 are expatriated foreign subsidiaries; and FP and FS are each a non-CFC foreign related person. All shares of stock have a fair market value of $1x, and each corporation has a single class of stock outstanding.

*Example 1. Specified exchange to which general rule applies*—(i) *Facts*. During the applicable period, and pursuant to a reorganization described in section 368(a)(1)(B), FT1 transfers all 50 shares of FT2 stock to FS in exchange solely for 50 newly issued voting shares of FS. Immediately before the exchange, USP is a section 1248 shareholder with respect to FT1 and FT2. At the time of the exchange, the FT2 stock owned by FT1 has a fair market value of $50x and an adjusted basis of $5x, such that the FT2 stock has a built-in gain of $45x. In addition, the earnings and profits of FT2 attributable to FT1's stock in FT2 for purposes of section 1248 is $30x, taking into account the rules of § 1.367(b)–2(c)(1)(i) and (ii), and therefore the section 1248 amount with respect to the FT2 stock is $30x (the lesser of the $45x of built-in gain and the $30x of earnings and profits attributable to the stock).

(ii) *Analysis*. FT1's exchange is a specified exchange because the requirements set forth in paragraphs (e)(2)(i) through (iii) of this section are satisfied. The requirement set forth in paragraph (e)(2)(i) of this section is satisfied because, immediately before the exchange, FT2 (the foreign acquired corporation) is an expatriated foreign subsidiary and FT1 (the exchanging shareholder) is an expatriated foreign subsidiary that is described in § 1.367(b)–4(b)(1)(i)(A)(*2*). The requirement set forth in paragraph (e)(2)(ii) of this section is also satisfied because the stock received in the exchange (FS stock) is stock of a foreign corporation. The requirement set forth in paragraph (e)(2)(iii) of this section is satisfied because the exchange occurs during the applicable period. Accordingly, under paragraph (e)(1)(i) of this section, FT1 must include in income as a deemed dividend $30x, the section 1248 amount with respect to its FT2 stock. In addition, under paragraph (e)(1)(ii) of this section, FT1 must, after taking into account the increase in basis provided in § 1.367(b)–2(e)(3)(ii) resulting from the deemed dividend (which increases FT1's basis in its FT2 stock from $5x to $35x), recognize $15x ($50x amount realized less $35x basis), the realized gain with respect to the FT2 stock that would not otherwise be recognized.

*Example 2. De minimis shift to non-CFC foreign related persons*—(i) *Facts*. The facts are the same as in the introductory sentences of this paragraph (e)(5) that precede *Example 1* of this paragraph (e)(5), except as follows. FT1 does not own any shares of FT2, and all 40 shares of FS are owned by DX, a domestic corporation wholly owned by individual A, and thus FS is not a non-CFC foreign related person. During the applicable period and pursuant to a reorganization described in section 368(a)(1)(D), FT1 transfers all of its assets to FS in exchange for 50 newly issued FS shares, FT1 distributes the 50 FS shares to USP in liquidation under section 361(c)(1), and USP exchanges its 50 shares of FT1 stock for the 50 FS shares under section 354. Further, immediately after the exchange, FS is a controlled foreign corporation.

(ii) *Analysis*. Although USP's exchange is a specified exchange, paragraph (e)(1) of this section does not apply to the exchange because, as described in paragraphs (ii)(A) through (C) of this *Example 2*, the requirements of paragraph (e)(3) of this section are satisfied.

(A) Because the assets, rather than the stock, of FT1 (the foreign acquired corporation) are acquired, the requirement set forth in paragraph (e)(3)(i) of this section is satisfied if FS (the transferee foreign corporation) is a controlled foreign corporation immediately after the exchange. As stated in the facts, FS is a controlled foreign corporation immediately after the exchange.

(B) The requirement set forth in paragraph (e)(3)(ii) of this section is satisfied if the post-exchange ownership percentage with respect to FS is at least 90% of the pre-exchange ownership percentage with respect to FT1. Because USP, a domestic corporation that is an expatriated entity, directly owns 50 shares of FT stock immediately before the exchange, none of those shares are treated as indirectly owned by FP (a non-CFC foreign related person) for purposes of calculating the pre-exchange ownership percentage with respect to FT1. See paragraph (g)(1) of this section. Thus, for purposes of calculating the pre-exchange ownership percentage with respect to FT1, FP is treated as directly or indirectly owning 0%, or 0 of 50 shares, of the stock of FT1. Accordingly, the pre-exchange ownership percentage with respect to FT1 is 100 (calculated as 100% less 0%, the percentage of FT1 stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately before the exchange). Consequently, for the requirement set forth in paragraph (e)(3)(ii) of this section to be satisfied, the post-exchange ownership percentage with respect to FS must be at least 90. Because USP, a domestic corporation that is an expatriated entity, directly owns 50 shares of FS stock immediately after the exchange, none of those shares are treated as indirectly owned by FP (a non-CFC foreign related person) for purposes of calculating the post-exchange ownership percentage with respect to FS. See paragraph (g)(1) of this section. Thus, for purposes of calculating the post-exchange ownership percentage with respect to FS, FP is treated as directly or indirectly owning 0%, or 0 of 90 shares, of the stock of FS. As a result, the post-exchange ownership percentage with respect to FS is 100 (calculated as 100% less 0%, the percentage of FS stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately after the exchange). Therefore, because the post-exchange ownership percentage with respect to FS (100) is at least 90, the requirement set forth in paragraph (e)(3)(ii) of this section is satisfied.

(C) Because there is not a lower-tier expatriated foreign subsidiary of FT1, the requirement set forth in paragraph (e)(3)(iii) of this section does not apply.

(f) *Gain recognition upon certain transfers of property described in section 351 following an inversion transaction*—(1) *General rule*. If, during the applicable period, an expatriated foreign subsidiary transfers specified property to a foreign corporation (the transferee foreign corporation) in an exchange described in section 351, then the expatriated foreign subsidiary must recognize all realized gain with respect to the specified property transferred that would not otherwise be recognized, unless the exception in paragraph (f)(2) of this section applies.

(2) *De minimis exception*. The exception in this paragraph (f)(2) applies if—

(i) Immediately after the transfer, the transferee foreign corporation is a controlled foreign corporation; and

(ii) The post-exchange ownership percentage with respect to the transferee foreign corporation is at least 90 percent of the pre-exchange ownership percentage with respect to the expatriated foreign subsidiary.

(3) *Examples*. The following examples illustrate the application of this paragraph (f). For purposes of all of the examples, unless otherwise indicated: FP, a foreign corporation, owns all of the stock of USP, a domestic corporation, and all 10 shares of stock of FS, a foreign corporation. USP owns all 50 shares of stock of FT, a controlled foreign corporation. FT owns Asset A, which is specified property with a fair market value of $50x and an adjusted basis of $10x. FP acquired all of the stock of USP in an inversion transaction that was completed on or after September 22, 2014. Accordingly, with respect to that inversion transaction, USP is an expatriated entity, FT is an expatriated foreign subsidiary, and FP and FS are each a non-CFC foreign related person. All shares of stock have a fair market value of $1x, and each corporation has a single class of stock outstanding.

*Example 1. Transfer to which general rule applies*—(i) *Facts*. In addition to the stock of USP and FS, FP owns Asset B, which has a fair market value of $40x. During the applicable period, and pursuant to an exchange described in section 351, FT transfers Asset A to FS in exchange for 50 newly issued shares of FS stock, and FP transfers Asset B to FS in exchange for 40 newly issued shares of FS stock. Immediately after the transfer, FS is not a controlled foreign corporation.

(ii) *Analysis*. Paragraph (f)(1) of this section applies to the transfer by FT (an expatriated foreign subsidiary) of Asset A, which is specified property, to FS (the transferee foreign corporation). Thus, FT must recognize gain of $40x under paragraph (f)(1) of this section, which is the realized gain with respect to Asset A that would not otherwise be recognized ($50x amount realized less $10x basis). For rules regarding whether the FS stock held by FT is treated as United States property for purposes of section 956, see § 1.956–2T(a)(4)(i).

*Example 2. De minimis shift to non-CFC foreign related persons*—(i) *Facts*. Individual, a United States person, owns Asset B, which has a fair market value of $40x. During the applicable period, and pursuant to an exchange described in section 351, FT transfers Asset A to FS in exchange for 50 newly issued shares of FS stock, and Individual transfers Asset B to FS in exchange for 40 newly issued shares of FS stock.

(ii) *Analysis*. Paragraph (f)(1) of this section does not apply to the transfer by FT (an expatriated foreign subsidiary) of Asset A, which is specified property, to FS (the transferee foreign corporation)) because the requirements set forth in paragraph (f)(2) of this section are satisfied. FS is a controlled foreign corporation immediately after the transfer because 90 out of FS's 100 outstanding shares are owned (within the meaning of section 958(a)) by Individual and USP, who are both United States shareholders (within the meaning of section 951(b)). Accordingly, the requirement set forth in paragraph (f)(2)(i) of this section is satisfied. The requirement set forth in paragraph (f)(2)(ii) of this section is satisfied if the post-exchange ownership percentage with respect to FS is at least 90 percent of the pre-exchange ownership percentage with respect to FT. Because USP, a domestic corporation that is an expatriated entity, directly owns 50 shares of FT stock immediately before the transfer, none of those shares are treated as indirectly owned by FP (a non-CFC foreign related person) for purposes of calculating the pre-exchange ownership percentage with respect to FT. See paragraph (g)(1) of this section. Thus, for purposes of calculating the pre-exchange ownership percentage with respect to FT, FP is treated as directly or indirectly owning 0 percent, or 0 of 50 shares, of the stock of FT. Accordingly, the pre-exchange ownership percentage with respect to FT is 100 (calculated as 100 percent less 0 percent, the percentage of FT stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately before the transfer). Consequently, for the requirement set forth in paragraph (f)(2)(ii) of this section to be satisfied, the post-exchange ownership percentage with respect to FS must be at least 90. Although FP directly owns 10 FS shares, none of the 50 FS shares that FP owns through USP (a domestic corporation that is an expatriated entity) are treated as indirectly owned by FP for purposes of calculating the post-exchange ownership percentage with respect to FS because USP directly owns them. See paragraph (g)(1) of this section. Thus, for purposes of calculating the post-exchange ownership percentage with respect to FS, FP is treated as directly or indirectly owning 10 percent, or 10 of 100 shares, of the stock of FS. As a result, the post-exchange ownership percentage with respect to FS is 90 (calculated as 100 percent less 10 percent, the percentage of FS stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately after the transfer). Therefore, because the post-exchange ownership percentage with respect to FS (90) is at least 90, the requirement set forth in paragraph (f)(2)(ii) of this section is satisfied.

(g) *Definitions and special rules*. In addition to the definitions and special rules in §§ 1.367(b)–2 and 1.7874–12T, the following definitions and special rules apply for purposes of this section and § 1.367(b)–4.

(1) *Indirect ownership*. To determine indirect ownership of the stock of a corporation for purposes of calculating a pre-

exchange ownership percentage or post-exchange ownership percentage with respect to that corporation, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or domestic. For this purpose, stock of the corporation that is directly or indirectly (applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic) owned by a domestic corporation that is an expatriated entity is not treated as indirectly owned by a non-CFC foreign related person.

(2) A *lower-tier expatriated foreign subsidiary* means an expatriated foreign subsidiary whose stock is directly or indirectly owned (under the principles of section 958(a)) by an expatriated foreign subsidiary.

(3) *Pre-exchange ownership percentage* means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately before an exchange, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(4) *Post-exchange ownership percentage* means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately after the exchange, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(5) *Specified property* means any property other than stock of a lower-tier expatriated foreign subsidiary.

(6) *Recapitalizations*. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as both the foreign acquired corporation and the transferee foreign corporation.

(7) *Triangular reorganizations*—(i) *Definition*. A triangular reorganization means a reorganization described in § 1.358–6(b)(2)(i) (forward triangular merger), (ii) (triangular C reorganization), (iii) (reverse triangular merger), (iv) (triangular B reorganization), and (v) (triangular G reorganization).

(ii) *Special rules*—(A) *Triangular reorganizations other than a reverse triangular merger*. In the case of a triangular reorganization other than a reverse triangular merger, the surviving corporation is the transferee foreign corporation that acquires the assets or stock of the foreign acquired corporation, and the reference to controlling corporation (foreign or domestic) is to the corporation that controls the surviving corporation.

(B) *Reverse triangular merger*. In the case of a reverse triangular merger, the surviving corporation is the entity that survives the merger, and the controlling corporation (foreign or domestic) is the corporation that before the merger controls the merged corporation. In the case of a reverse triangular merger, § 1.367(b)–4 and this section apply only if stock of the foreign surviving corporation is exchanged for stock of a foreign corporation in control of the merging corporation; in such a case, the foreign surviving corporation is treated as a foreign acquired corporation.

(h) *Applicability date of certain paragraphs in this section*. Except as otherwise provided in this paragraph (h), this section applies to exchanges completed on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (e)(1)(ii) of this section applies to exchanges completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. The portion of paragraph (e)(2)(i) of this section that requires the exchanging shareholder to be an expatriated entity or an expatriated foreign subsidiary apply to exchanges completed on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply the portion of paragraph (e)(2)(i) of this section that requires the exchanging shareholder to be an expatriated entity or an expatriated foreign subsidiary to exchanges completed on or after September 22, 2014, and before April 4, 2016. Paragraphs (f) and (g)(5) of this section apply to transfers completed on or after April 4, 2016, but only if the inversion transaction was completed or after September 22, 2014. See § 1.367(b)–4, as contained in 26 CFR part 1 revised as of April 1, 2016, for exchanges completed before September 22, 2014.

(i) *Expiration date*. This section expires on or before April 4, 2019.

Par. 8. Section 1.956–2 is amended by:
1. Adding paragraphs (a)(4) and (c)(5).
2. Revising paragraph (d)(2).
3. Adding reserved paragraphs (f), (g), and (h).
4. Adding paragraph (i).

The additions and revision read as follows:

*§ 1.956–2 Definition of United States property.*

(a) * * *

(4) [Reserved]. For further guidance, see § 1.956–2T(a)(4).

* * * * *

(c) * * *

(5) [Reserved]. For further guidance, see § 1.956–2T(c)(5).

(d) * * *

(2) [Reserved]. For further guidance, see § 1.956–2T(d)(2).

* * * * *

(f) [Reserved]

(g) [Reserved]

(h) [Reserved]

(i) [Reserved]. For further guidance, see § 1.956–2T(i).

Par. 9. Section 1.956–2T is amended by:
1. Adding paragraphs (a)(4) and (c)(5).
2. Revising paragraph (d)(2).
3. Adding reserved paragraph (h).
4. Adding paragraphs (i) and (j).

The additions and revision read as follows:

*§ 1.956–2T Definition of United States property (temporary).*

(a)(1) through (3) [Reserved]. For further guidance, see § 1.956–2(a)(1) through (3).

(4) *Certain foreign stock and obligations held by expatriated foreign subsidiaries following an inversion transaction*—(i) *General rule*. Except as provided in paragraph (a)(4)(ii) of this section, for purposes of section 956 and § 1.956–2(a), United States property includes an obligation of a foreign person and stock of a foreign corporation when the following conditions are satisfied—

(A) The obligation or stock is held by a controlled foreign corporation that is an expatriated foreign subsidiary, regardless of whether, when the obligation or stock was acquired, the acquirer was a controlled foreign corporation or an expatriated foreign subsidiary;

(B) The foreign person or foreign corporation is a non-CFC foreign related person, regardless of whether, when the obligation or stock was acquired, the foreign person or foreign corporation was a non-CFC foreign related person; and

(C) The obligation or stock was acquired—

(*1*) During the applicable period; or

(*2*) In a transaction related to the inversion transaction.

(ii) *Exceptions*. For purposes of section 956 and § 1.956–2(a), United States property does not include—

(A) Any obligation of a non-CFC foreign related person arising in connection with the sale or processing of property if the amount of the obligation at no time during the taxable year exceeds the amount that would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the non-CFC foreign related person had the sale or processing transaction been made between unrelated persons; and

(B) Any obligation of a non-CFC foreign related person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities.

(iii) *Definitions*. The definitions in § 1.7874–12T apply for the purposes of the application of paragraphs (a)(4), (c)(5), and (d)(2) of this section.

(iv) *Examples*. The following examples illustrate the rules of this paragraph (a)(4). For purposes of the examples, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015.

*Example 1*. (A) *Facts*. FT acquired an obligation of FS on January 31, 2015.

(B) *Analysis*. Pursuant to § 1.7874–12T, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FS is a non-CFC foreign related person. In addition, FT acquired the FS obligation during the applicable period. Thus, as of January 31, 2015, the obligation of FS is United States property with respect to FT for purposes of section 956(a) and § 1.956–2(a).

*Example 2*. (A) *Facts*. The facts are the same as in *Example 1* of this paragraph (a)(4)(iv), except that on February 15, 2015, FT contributed assets to FS in exchange for 60% of the stock of FS, by vote and value.

(B) *Analysis*. As a result of the transaction on February 15, 2015, FS becomes a controlled foreign corporation with respect to which an expatriated entity, DT, is a United States shareholder. Accordingly, under § 1.7874–12T(a)(9), FS is an expatriated foreign subsidiary, and is therefore not a non-CFC foreign related person. Thus, as of February 15, 2015, the stock and obligation of FS are not United States property with respect to FT for purposes of section 956(a) and § 1.956–2(a). FS is not excluded from the definition of expatriated foreign subsidiary pursuant to § 1.7874–12T(a)(9)(ii) because FS was not a CFC on the completion date.

*Example 3*. (A) *Facts*. Before the acquisition, FA also wholly owns USP, a domestic corporation, which, in turn, wholly owns, LFS, a foreign corporation that is a controlled foreign corporation. DT was not a United States shareholder of LFS on or before the completion date. On January 31, 2015, FT contributed assets to LFS in exchange for 60% of the stock of LFS, by vote and value. FT acquired an obligation of LFS on February 15, 2015.

(B) *Analysis*. LFS is a foreign related person. Because LFS was a controlled foreign corporation and a member of the expanded affiliated group with respect to the inversion transaction on the completion date, and DT was not a United States shareholder with respect to LFS on or before the completion date, LFS is excluded from the definition of expatriated foreign subsidiary pursuant to § 1.7874–12T(a)(9)(ii). Thus, pursuant to § 1.7874–12T(a)(16), LFS is a non-CFC foreign related person, and the stock and obligation of LFS are United States property with respect to FT for purposes of section 956(a) and § 1.956–2(a). The fact that FT contributed assets to LFS in exchange for 60% of the stock of LFS does not change this result.

*Example 4*. (A) *Facts*. The facts are the same as in *Example 3* of this paragraph (a)(4)(iv), except that on February 10, 2015, LFS organized a new foreign corporation (LFSS), transferred all of its assets to LFSS, and liquidated, in a transaction treated as a reorganization described in section 368(a)(1)(F), and FT acquired an obligation of LFSS, instead of LFS, on February 15, 2015. On March 1, 2015, LFSS acquired an obligation of FS.

(B) *Analysis*. LFS is a controlled foreign corporation with respect to which USP, an expatriated entity, is a United States shareholder. USP is an expatriated entity because on the completion date, USP and DT became related to each other within the meaning of section 267(b). Because LFSS was not a member of the expanded affiliated group with respect to the inversion transaction on the completion date, LFSS is not excluded from the definition of expatriated foreign subsidiary pursuant to § 1.7874–12T(a)(9)(ii). Accordingly, under § 1.7874–12T(a)(9)(i), LFFS is an expatriated foreign subsidiary and is therefore not a non-CFC foreign related person. Thus, the stock and obligation of LFSS are not United States property with respect to FT for purposes of section 956(a) and § 1.956–2(a). However, because LFSS is an expatriated foreign subsidiary, pursuant to § 1.7874–12T(a)(9), the obligation of FS, a non-CFC foreign related person, is United States property with respect to LFSS for purposes of section 956(a) and § 1.956–2(a).

(b)(1) through (b)(1)(x) [Reserved]. For further guidance, see § 1.956–2(b)(1) through (b)(1)(x).

* * * * *

(b)(2) through (c)(4) [Reserved]. For further guidance, see § 1.956–2(b)(2) through (c)(4).

(5) *Special guarantee and pledge rule for expatriated foreign subsidiaries*—(i) *General rule*. In applying § 1.956–2(c)(1) and (2) to a controlled foreign corporation that is an expatriated foreign subsidiary, the phrase "of a United States person or a non-CFC foreign related person" is substituted for the phrase "of a United States person" each place it appears.

(ii) *Additional rules*. The rule in paragraph (c)(5)(i) of this section—

(A) Applies regardless of whether, when the pledge or guarantee was entered into or treated as entered into, the controlled foreign corporation was a controlled foreign corporation or an expatriated foreign subsidiary, or a foreign person whose obligation is subject to the pledge or guarantee, or deemed pledge or guarantee, was a non-CFC foreign related person; and

(B) Applies to pledges or guarantees entered into, or treated pursuant to § 1.956–2(c)(2) as entered into—

(*1*) During the applicable period; or

(*2*) In a transaction related to the inversion transaction.

(d)(1) [Reserved]. For further guidance, see § 1.956–2(d)(1).

(2) *Obligation defined*. For purposes of section 956 and § 1.956–2, the term "obligation" includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not

bearing interest, except that the term does not include—

(i) Any indebtedness arising out of the involuntary conversion of property which is not United States property within the meaning of § 1.956–2(a)(1) or § 1.956–2T(a);

(ii) Any obligation of a United States person (as defined in section 957(c)) arising in connection with the provision of services by a controlled foreign corporation to the United States person if the amount of the obligation outstanding at any time during the taxable year of the controlled foreign corporation does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the controlled foreign corporation and the United States person if they were unrelated. The amount of the obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days;

(iii) Any obligation of a non-CFC foreign related person arising in connection with the provision of services by an expatriated foreign subsidiary to the non-CFC foreign related person if the amount of the obligation outstanding at any time during the taxable year of the expatriated foreign subsidiary does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the expatriated foreign subsidiary and the non-CFC foreign related person if they were unrelated. The amount of the obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days;

(iv) Unless a controlled foreign corporation applies the exception provided in paragraph (d)(2)(v) of this section with respect to the obligation, any obligation of a United States person (as defined in section 957(c)) that is collected within 30 days from the time it is incurred (a *30-day obligation*), unless the controlled foreign corporation that holds the 30-day obligation holds for 60 or more calendar days during the taxable year in which it holds the 30-day obligation any obligations which, without regard to the exclusion described in this paragraph (d)(2)(iv), would constitute United States property within the meaning of section 956 and § 1.956–2(a); or

(v) Unless a controlled foreign corporation applies the exception provided in paragraph (d)(2)(iv) of this section with respect to the obligation, any obligation of a United States person (as defined in section 957(c)) that is collected within 60 days from the time it is incurred (a *60-day obligation*), unless the controlled foreign corporation that holds the 60-day obligation holds for 180 or more calendar days during the taxable year in which it holds the 60-day obligation any obligations which, without regard to the exclusion described in this paragraph (d)(2)(v), would constitute United States property within the meaning of section 956 and § 1.956–2(a).

* * * * *

(h) [Reserved]

(i) *Effective/applicability date*. (1) Except as otherwise provided in this paragraph (i)(1), paragraphs (a)(4) and (c)(5) of this section apply to obligations or stock acquired or to pledges or guarantees entered into, or treated as entered into, on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. The phrase, "regardless of whether, when the obligation or stock was acquired, the acquirer was a controlled foreign corporation or an expatriated foreign subsidiary" in paragraph (a)(4)(i)(A) of this section, the phrase "regardless of whether, when the obligation or stock was acquired, the foreign person or foreign corporation was a non-CFC foreign related person" in paragraph (a)(4)(i)(B) of this section, and paragraphs (a)(4)(i)(C)(*2*), (c)(5)(ii)(A), and (c)(5)(ii)(B)(*2*) of this section apply to obligations or stock acquired or pledges or guarantees entered into or treated as entered into on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (a)(4)(ii) of this section applies to obligations acquired on or after April 4, 2016. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (a)(4)(ii) of this section to an obligation acquired before April 4, 2016. For purposes of paragraph (a)(4)(i) of this section and this paragraph (i)(1), a deemed exchange of an obligation or stock pursuant to section 1001 constitutes an acquisition of the obligation or stock. For purposes of paragraph (c)(5) of this section and this paragraph (i)(1), a pledgor or guarantor or deemed pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor or is treated as a pledgor or guarantor.

(2) Paragraphs (d)(2)(i) and (ii) of this section are effective June 14, 1988, with respect to investments made on or after June 14, 1988.

(3) Paragraph (d)(2)(iii) of this section applies to obligations acquired on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (d)(2)(iii) of this section to an obligation acquired on or after September 22, 2014, and before April 4, 2016. For purposes of paragraph (d)(2)(iii) of this section and this paragraph (i)(3), a significant modification, within the meaning of § 1.1001–3(e), of an obligation on or after April 4, 2016, constitutes an acquisition of an obligation on or after April 4, 2016.

(4) Paragraph (d)(2)(iv) of this section applies to obligations held on or after September 16, 1988.

(5) Paragraph (d)(2)(v) of this section applies to the first three taxable years of a foreign corporation ending after October 3, 2008, other than taxable years of a foreign corporation beginning on or after January 1, 2011, as well as the fourth taxable year of a foreign corporation, if any, when the foreign corporation's third taxable year (including any short taxable year) ended after October 3, 2008, and on or before December 31, 2009.

(j) *Expiration date*. The applicability of paragraphs (a)(4), (c)(5), and (d)(2) of this section expires on or before April 4, 2019.

Par. 10. Section 1.7701(l)–4T is added to read as follows:

*§ 1.7701(l)–4T Rules regarding inversion transactions (temporary).*

(a) *Overview*. This section provides rules applicable to United States shareholders of controlled foreign corporations after certain inversion transactions. Paragraph (b) of this section defines specified transactions and provides the scope of the rules in this section. Paragraph (c) of this section provides rules recharacterizing certain specified transactions. Paragraph (d) of this section sets forth rules governing transactions that affect the stock of an expatriated foreign subsidiary following a recharacterized specified transaction. Paragraph (e) of this section sets forth a rule concerning the treatment of amounts included in income as a result of a specified transaction as foreign personal holding company income. Paragraph (f) of this section sets forth definitions that apply for purposes of this section. Paragraph (g) of this section sets forth examples illustrating these rules. Paragraph (h) of this section provides applicability dates, and paragraph (i) of this section provides the date of expiration. See § 1.367(b)–4T(e) for rules concerning certain other exchanges after an inversion transaction. See also § 1.956–2T(a)(4), (c)(5), and (d)(2) for additional rules applicable to United States property held by controlled foreign corporations after an inversion transaction.

(b) *Specified transaction*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, paragraph (c) of this section applies to specified transactions. For purposes of this section, a *specified transaction* is, with respect to an expatriated foreign subsidiary, a transaction in which stock of the expatriated foreign subsidiary is issued or transferred to a person that immediately before the issuance or transfer is a specified related person, provided the transaction occurs during the applicable period. However, a specified transaction does not include a transaction in which stock of the expatriated foreign subsidiary is deemed issued pursuant to section 304.

(2) *Exceptions*. Paragraph (c) of this section does not apply to a specified transaction—

(i) That is a fast-pay arrangement that is recharacterized under § 1.7701(l)–3(c)(2);

(ii) In which the specified stock was transferred by a shareholder of the expatriated foreign subsidiary, and the shareholder either—

(A) Pursuant to § 1.367(b)–4T(e)(1), both—

(*1*) Included in gross income as a deemed dividend the section 1248 amount attributable to the specified stock; and

(*2*) After taking into account the increase in basis provided in § 1.367(b)–2(e)(3)(ii) resulting from the deemed dividend (if any), recognized all realized gain with respect to the stock that otherwise would not have been recognized; or

(B) Included in gross income all of the gain recognized on the transfer of the specified stock (including gain included in gross income as a dividend pursuant to section 964(e), section 1248(a), or section 356(a)(2)); or

(iii) In which—

(A) Immediately after the specified transaction and any related transaction, the expatriated foreign subsidiary is a controlled foreign corporation;

(B) The post-transaction ownership percentage with respect to the expatriated foreign subsidiary is at least 90 percent of the pre-transaction ownership percentage with respect to the expatriated foreign subsidiary; and

(C) The post-transaction ownership percentage with respect to any lower-tier expatriated foreign subsidiary is at least 90 percent of the pre-transaction ownership percentage with respect to the lower-tier expatriated foreign subsidiary. See *Example 3* and *Example 4* of paragraph (g) of this section.

(c) *Recharacterization of specified transactions*—(1) *In general*. Except as otherwise provided, a specified transaction that is recharacterized under this paragraph (c) is recharacterized for all purposes of the Internal Revenue Code as of the date on which the specified transaction occurs, unless and until the rules of paragraph (d) of this section apply to alter or terminate the recharacterization. For purposes of paragraphs (c)(2) and (3) and (d) of this section, stock is considered owned by a section 958(a) U.S. shareholder if it is owned within the meaning of section 958(a) by the section 958(a) U.S. shareholder.

(2) *Specified transactions through stock issuance*. A specified transaction in which the specified stock is issued by an expatriated foreign subsidiary to a specified related person is recharacterized as follows—

(i) The transferred property is treated as having been transferred by the specified related person to the persons that were section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction, in proportion to the stock of the expatriated foreign subsidiary owned by each section 958(a) U.S. shareholder, in exchange for deemed instruments in the section 958(a) U.S. shareholders; and

(ii) The transferred property treated as transferred to the section 958(a) U.S. shareholders pursuant to paragraph (c)(2)(i) of this section is treated as having been contributed by the section 958(a) U.S. shareholders (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the expatriated foreign subsidiary in exchange for deemed issued stock in the expatriated foreign subsidiary. See *Example 1*, *Example 2*, and *Example 6* of paragraph (g) of this section.

(3) *Specified transactions through shareholder transfer*. A specified transaction in which specified stock is transferred by shareholders of the expatriated foreign subsidiary to a specified related person is recharacterized as follows—

(i) The transferred property is treated as having been transferred by the specified related person to the persons that were section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction, in proportion to the specified stock owned by each section 958(a) U.S. shareholder, in exchange for deemed instruments in the section 958(a) U.S. shareholders; and

(ii) To the extent the section 958(a) U.S. shareholders are not the transferring shareholders, the transferred property treated as transferred to the section 958(a) U.S. shareholders pursuant to paragraph (c)(3)(i) of this section is treated as having been contributed by the section 958(a) U.S. shareholders (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the transferring shareholder in exchange for equity in the transferring shareholder. See *Example 5* of paragraph (g) of this section.

(4) *Treatment of deemed instruments following a recharacterized specified transaction*—(i) *Deemed instruments*. The deemed instruments described in

paragraphs (c)(2) and (3) of this section have the same terms as the specified stock issued or transferred pursuant to the specified transaction (that is, the disregarded specified stock), other than the issuer. When a distribution is made with respect to the disregarded specified stock, matching seriatim distributions with respect to the deemed issued stock are treated as made by the expatriated foreign subsidiary, through intermediate entities, if any, to the section 958(a) U.S. shareholders, which, in turn, then are treated as making corresponding payments with respect to the deemed instruments to the specified related person.

(ii) *Paying agent*. The expatriated foreign subsidiary is treated as the paying agent of the section 958(a) U.S. shareholder with respect to the deemed instruments treated as issued by the section 958(a) U.S. shareholder to the specified related person.

(d) *Transactions affecting ownership of stock of an expatriated foreign subsidiary following a recharacterized specified transaction*—(1) *Transfers of stock other than specified stock*. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, stock of the expatriated foreign subsidiary, other than disregarded specified stock, that is owned by a section 958(a) U.S. shareholder is transferred, the deemed issued stock treated as owned by the section 958(a) U.S. shareholder as a result of the specified transaction continues to be treated as directly owned by the holder, as are the deemed instruments treated as issued to the specified related person as a result of the specified transaction.

(2) *Transactions in which the expatriated foreign subsidiary ceases to be a foreign related person*. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, there is a transaction that affects the ownership of the stock (including disregarded specified stock) of the expatriated foreign subsidiary, and, immediately after the transaction, the expatriated foreign subsidiary is not a foreign related person (determined without taking into account the recharacterization under paragraph (c)(2) or (3) of this section), then, immediately before the transaction—

(i) Each section 958(a) U.S. shareholder that is treated as owning deemed issued stock in the expatriated foreign subsidiary under paragraph (c)(2) or (3) of this section is treated as transferring the deemed issued stock (after the deemed issued stock is deemed to be transferred to the section 958(a) U.S. shareholder through intermediate entities, if any, in redemption of equity deemed issued by the intermediate entities pursuant to paragraph (c)(2) or (3) of this section) to the specified related person that is treated as holding the deemed instruments issued by the section 958(a) U.S. shareholder under paragraph (c)(2) or (3) of this section, in redemption of the deemed instruments; and

(ii) The deemed issued stock that is treated as transferred pursuant to paragraph (d)(2)(i) of this section is treated as recapitalized into the disregarded specified stock actually held by the specified related person, which immediately thereafter is treated as specified stock owned by the specified related person for all purposes of the Internal Revenue Code. See *Example 8*, *Example 9*, and *Example 12* of paragraph (g) of this section.

(3) *Transfers in which disregarded specified stock ceases to be held by a foreign related person, specified related person, or expatriated entity*. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, there is a direct or indirect transfer of the disregarded specified stock in the expatriated foreign subsidiary, and immediately after the transfer, the expatriated foreign subsidiary is a foreign related person, then, to the extent that, as a result of the transfer, the disregarded specified stock is actually held (determined without taking into account the recharacterization under paragraph (c)(2) or (3) of this section) by a person that is not a foreign related person, a specified related person, or an expatriated entity, immediately before the transfer—

(i) Each section 958(a) U.S. shareholder that is treated as owning all or a portion of the deemed issued stock in the expatriated foreign subsidiary is treated as transferring the deemed issued stock that is allocable to the transferred disregarded specified stock that is out-of-group transferred disregarded specified stock (after the deemed issued stock is deemed to be transferred to the section 958(a) U.S. shareholder through intermediate entities, if any, in redemption of equity deemed issued by the intermediate entities pursuant to paragraph (c)(2) or (3) of this section) to the specified related person that is treated as holding the deemed instruments allocable to the out-of-group transferred disregarded specified stock, in redemption of the deemed instruments that are allocable to the out-of-group transferred disregarded specified stock; and

(ii) The deemed issued stock that is treated as transferred pursuant to paragraph (d)(3)(i) of this section is treated as recapitalized into the disregarded specified stock actually held by the specified related person, which immediately thereafter is treated as specified stock owned by the specified related person for all purposes of the Internal Revenue Code. See *Example 7* and *Example 11* of paragraph (g) of this section.

(4) *Certain direct transfers of disregarded specified stock to which unwind rules do not apply*. When a specified related person directly transfers the disregarded specified stock of the expatriated foreign subsidiary and paragraphs (d)(2) and (3) of this section do not apply with respect to the transfer, the specified related person is deemed to transfer the deemed instruments allocable to the transferred disregarded specified stock, whether it is in-group transferred disregarded specified stock or out-of-group transferred disregarded specified stock, to the transferee of the specified stock, in lieu of the disregarded specified stock, in exchange for the consideration provided by the transferee for the disregarded specified stock. See *Example 10* of paragraph (g) of this section.

(5) *Determination of deemed issued stock and deemed instruments allocable to transferred disregarded specified stock*—(i) *Out-of-group transfers of disregarded specified stock*. For purposes of paragraphs (d)(3) and (4) of this section, the portion of the deemed issued stock treated as owned, and of the deemed instruments treated as issued, by each section 958(a)

U.S. shareholder as a result of the specified transaction that is allocable to out-of-group transferred disregarded specified stock is the amount that is proportionate to the ratio of the amount of the out-of-group transferred disregarded specified stock to the amount of disregarded specified stock of the expatriated foreign subsidiary that is actually held by the specified related person immediately before the transfer referred to in paragraph (d)(3) or (4) of this section as a result of the specified transaction.

(ii) *In-group direct transfers of disregarded specified stock*. For purposes of paragraph (d)(4) of this section, the portion of the deemed issued stock treated as owned by each section 958(a) U.S. shareholder as a result of the specified transaction that is allocable to in-group transferred disregarded specified stock is the amount that is proportionate to the ratio of the amount of the in-group transferred disregarded specified stock to the amount of disregarded specified stock of the expatriated foreign subsidiary that is actually held by the specified related person immediately before the transfer described in paragraph (d)(4) of this section as a result of the specified transaction.

(e) *Certain exception from foreign personal holding company income not available*. An amount included in the gross income of a controlled foreign corporation as a dividend with respect to stock transferred in a specified transaction does not qualify for the exception from foreign personal holding company income provided by section 954(c)(6) (to the extent in effect).

(f) *Definitions*. In addition to the definitions in § 1.7874–12T, the following definitions and special rules apply for purposes of this section:

(1) *Deemed instruments* mean, with respect to a specified transaction, instruments deemed issued by a section 958(a) U.S. shareholder in exchange for transferred property in the specified transaction.

(2) *Deemed issued stock* means, with respect to a specified transaction, stock of an expatriated foreign subsidiary deemed issued to a section 958(a) U.S. shareholder (or an intermediate entity) in the specified transaction.

(3) *Disregarded specified stock* means, with respect to a specified transaction, specified stock that is actually held by a specified related person but that is disregarded for all purposes of the Internal Revenue Code pursuant to paragraph (c)(2) or (3) of this section.

(4) *Indirect ownership*. To determine indirect ownership of the stock of a corporation for purposes of calculating a pre-transaction ownership percentage or post-transaction ownership percentage with respect to that corporation, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or domestic. For this purpose, stock of the corporation that is directly or indirectly (applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic) owned by a domestic corporation that is an expatriated entity is not treated as indirectly owned by a non-CFC foreign related person.

(5) *In-group transferred disregarded specified stock* means disregarded specified stock that is directly transferred to a foreign related person, a specified related person, or an expatriated entity.

(6) A *lower-tier expatriated foreign subsidiary* means an expatriated foreign subsidiary, stock of which is directly or indirectly owned by an expatriated foreign subsidiary.

(7) *Out-of-group transferred disregarded specified stock* means disregarded specified stock that, as a result of a transfer of disregarded specified stock, is actually held by a person that is not a foreign related person, a specified related person, or an expatriated entity.

(8) *Pre-transaction ownership percentage* means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately before a specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(9) *Post-transaction ownership percentage* means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately after the specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(10) A *section 958(a) U.S. shareholder* means, with respect to an expatriated foreign subsidiary, a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock of the expatriated foreign subsidiary and that is an expatriated entity.

(11) *Specified stock* means the stock of the expatriated foreign subsidiary that is issued or transferred to a specified related person in a specified transaction.

(12) *Transferred property* means the property transferred by the specified related person in exchange for specified stock in a specified transaction.

(g) *Examples*. The following examples illustrate the regulations described in this section. Except as otherwise provided, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015. Accordingly, DT is the domestic entity and a section 958(a) U.S. shareholder with respect to FT, FT is an expatriated foreign subsidiary, and FA and FS are non-CFC foreign related persons and specified related persons.

*Example 1*. (i) *Facts*. On February 1, 2015, FA acquires $6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $6x of cash.

(ii) *Analysis*. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period. Furthermore, the exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) FA's acquisition of the FT specified stock is recharacterized under paragraphs (c)(1) and (2) of this section as follows, with the result that FT continues to be a CFC:

(*1*) DT is treated as having issued deemed instruments to FA in exchange for $6x of cash.

(*2*) DT is treated as having contributed the $6x of cash to FT in exchange for deemed issued stock of FT.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock issued to FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FA. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FA.

*Example 2*. (i) *Facts*. DT owns stock of FT representing 60% of the total voting power and value of the stock of FT, and the remaining stock of FT, representing 40% of the total voting power and value, is owned by USP, a domestic corporation that is not an expatriated entity. On February 1, 2015, FA acquires $6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $6x of cash.

(ii) *Analysis*. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period. Furthermore, the exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) FA's acquisition of the FT specified stock is recharacterized under paragraphs (c)(1) and (2) of this section as follows, with the result that FT continues to be a CFC:

(*1*) DT is treated as having issued deemed instruments to FA in exchange for $6x of cash.

(*2*) DT is treated as having contributed the $6x of cash to FT in exchange for deemed issued stock of FT.

(*3*) DT is treated as owning $8.40x of the stock of FT, representing 84% of the total voting power and value of the stock of FT. USP owns $1.60x of the stock of FT, representing 16% of the total voting power and value of the stock of FT.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock issued to FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FA. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FA.

*Example 3*. (i) *Facts*. DT owns stock of FT representing 50% of the total voting power and value of the $8x of stock of FT outstanding, and the remaining stock of FT, representing 50% of the total voting power and value, is owned by USP, a domestic corporation that is not an expatriated entity. On April 30, 2016, FA and USP each simultaneously acquire $1x of FT stock from FT in a stock issuance, in exchange for $1x of cash each.

(ii) *Analysis*. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period.

(B) However, the specified transaction is not recharacterized under paragraphs (c)(1) and (2) of this section because the exception in paragraph (b)(2)(iii) of this section applies. The exception applies because FT remains a controlled foreign corporation immediately after the specified transaction and any related transaction, and the post-transaction ownership percentage with respect to FT is 90% (90%/100%), or at least 90%, of the pre-transaction ownership percentage with respect to FT. The rule in paragraph (b)(2)(iii)(C) of this section does not apply because there is no lower-tier expatriated foreign subsidiary. Although FA (a non-CFC foreign related person) indirectly owns $4x of FT stock both immediately before and after the specified transaction and any related transaction, all of that stock is directly owned by DT (a domestic corporation that is a section 958(a) U.S. shareholder of FT), and as a result, under paragraph (f)(4) of this section, none of that stock is treated as directly or indirectly owned by FP for purposes of calculating the pre-transaction ownership percentage and the post-transaction ownership percentage with respect to FT. Accordingly, under paragraph (f)(8) of this section, the pre-transaction ownership percentage with respect to FT (100% less the percentage of stock (by value) in FT that, immediately before the specified transaction with respect to FT and any related transaction, is owned by non-CFC foreign related persons) is 100 (100% – 0%). Under paragraph (f)(9) of this section, the post-transaction ownership percentage with respect to FT (100% less the percentage of stock (by value) in FT that, immediately after the specified transaction with respect to FT and any related transaction, is owned by non-CFC foreign related persons) is 90 (100% – 10% ($1x/$10x)).

*Example 4*. (i) *Facts*. On February 1, 2015, FA acquires 60% of the FT stock owned by DT in exchange for $2.40x of cash in a fully taxable transaction. DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FA.

(ii) *Analysis*. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock is a specified transaction because stock of an expatriated foreign subsidiary was transferred to a specified related person (FA) during the applicable period.

(B) However, the specified transaction is not recharacterized under paragraphs (c)(1) and (c)(3) of this section because the exception in paragraph (b)(2)(ii) of this section applies. The exception applies because DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT specified stock transferred to FA.

*Example 5*. (i) *Facts*. On February 1, 2015, DT and FA organize FPRS, a foreign partnership, with nominal capital. DT transfers all of the stock of FT to FPRS in exchange for 40% of the capital and profits interests in the partnership. Furthermore, FA contributes property to FPRS in exchange for the other 60% of the capital and profits interests.

(ii) *Analysis*. (A) Under paragraph (b) of this section, DT's transfer of the FT specified stock is a specified transaction, because stock of an expatriated foreign subsidiary was transferred to a specified related person (FPRS) during the applicable period. The exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) DT's transfer of the FT specified stock is recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows, with the result that FT continues to be a CFC:

(*1*) FPRS is treated as having issued 40% of its capital and profits interests to DT in exchange for deemed instruments treated as having been issued by DT.

(*2*) DT is treated as continuing to own all of the stock of FT, as well as the FPRS interests.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock transferred to FPRS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FPRS. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FPRS.

*Example 6*. (i) *Facts*. DT wholly owns FT2, a foreign corporation that is a controlled foreign corporation. FT and FT2 each own 50% of the capital and profits interests in DPRS, a domestic partnership. DPRS wholly owns FT3, a foreign corporation that is a controlled foreign corporation. FT2 and FT3 are expatriated foreign subsidiaries. On April 30, 2016, FS acquires $9x of the stock of each of FT and FT2, representing 9% of the total voting power and value of the stock of FT and FT2, from FT and FT2, respectively, in a stock issuance, in exchange for cash of $9x each. Also on April 30, 2016, in a related transaction, FS acquires $9x of the stock of FT3, representing 9% of the total voting power and value of the stock of FT3, from FT3 in a stock issuance, in exchange for cash of $9x.

(ii) *Analysis*. (A) Under paragraph (b) of this section, the acquisitions by FS of the specified stock of each of FT, FT2, and FT3 from FT, FT2, and FT3 are specified transactions with respect to each of FT, FT2, and FT3, respectively, because stock of an expatriated foreign subsidiary was issued to a specified related person (FS) during the applicable period.

(B) If FS had acquired only stock of FT and FT2, and had not acquired stock of FT3 in a related transaction, the specified transactions resulting from the acquisitions with respect to FT and FT2 would not have been recharacterized under paragraphs (c)(1) and (2) of this section, because the exception from recharacterization in paragraph (b)(2)(iii) of this section would have applied. FT and FT2 remain controlled foreign corporations (within the meaning of section 957) immediately after each specified transaction and any related transaction. Under paragraph (f)(9) of this section, the post-transaction ownership percentage with respect to each of FT, FT2, and FT3 (a lower-tier expatriated foreign subsidiary of FT and FT2) would have been 91% ((100% – 9%)/(100% – 0%)), or at least 90%, of the pre-transaction ownership percentage determined under paragraph (f)(8) of this section with respect to each of FT, FT2, and FT3 (100%).

(C) However, for the specified transactions with respect to FT, FT2, and FT3, the post-transaction ownership percentage determined under paragraph (f)(9) of this section with respect to FT3 (the lower-tier expatriated foreign subsidiary of FT and FT2), 100% less the percentage of stock (by value) in FT3 that, immediately after each of the specified transactions with respect to each of FT and FT2 and any related transaction, is owned by the non-CFC foreign related persons, is 82.81 (100%–(9%x50%x91%)–(9%x50%x91%)–9%). Accordingly, the post-transaction ownership percentage with respect to FT3 is 82.81% (82.81/(100%–0%)), which is less than 90%, of the pre-transaction ownership percentage determined under paragraph (f)(8) of this section with respect to FT3. Thus, the exception from recharacterization in paragraph (b)(2)(iii) of this section does not apply with respect to the specified transactions with respect to FT, FT2, or FT3.

(D) The specified transactions with respect to FT and FT2 are recharacterized under paragraphs (c)(1) and (2) of this section as follows:

(*1*) DT is treated as having issued 2 deemed instruments worth $9x each to FA in exchange for $18x ($9x + $9x) of cash.

(*2*) DT is treated as having contributed $9x of cash to each of FT and FT2 in exchange for deemed issued stock of FT and FT2.

(*3*) DT is treated as continuing to own all of the stock of FT and FT2.

(E) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT and FT2 specified stock issued to FS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FS. Under paragraph (c)(4)(ii) of this section, FT and FT2 are treated as the paying agents of DT with respect to the deemed instruments issued by DT to FS.

(F) The specified transaction with respect to FT3 is recharacterized under paragraphs (c)(1) and (2) of this section as follows:

(*1*) DPRS is treated as having issued a deemed instrument worth $9x to FA in exchange for $9x of cash.

(*2*) DPRS is treated as having contributed $9x of cash to FT3 in exchange for deemed issued stock of FT3.

(*3*) DPRS is treated as continuing to own all of the stock of FT3.

(G) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT3 specified stock issued to FS will be treated as a distribution to DPRS, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DPRS is treated as having issued to FS. Under paragraph (c)(4)(ii) of this section, FT3 is treated as the paying agent of DPRS with respect to the deemed instrument issued by DPRS to FS.

*Example 7*. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FA transfers $4x of the FT disregarded specified stock that it acquired on February 1, 2015 to USP, a domestic corporation that is not an expatriated entity, in exchange for $4x of cash.

(ii) *Results*. After the transfer, FT remains a foreign related person. Therefore, paragraph (d)(2) of this section does not apply. However, the $4x of FT disregarded specified stock transferred to USP ceases to be held by a foreign related person, a specified related person, or an expatriated entity (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(3) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer $4x ($6x x ($4x/$6x)) of the FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of $4x ($6x x ($4x/$6x)) of the DT deemed instruments that FA is treated as owning, and the $4x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

*Example 8*. (i) *Facts*. The facts are the same as in *Example 7* of this paragraph (g), except that on April 30, 2016, FA transfers all $6x of the FT disregarded specified stock to USP in exchange for $6x of cash.

(ii) *Results*. After the transfer, FT ceases to be a foreign related person (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(2) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer the $6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $6x of DT deemed instruments that FA is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

*Example 9*. (i) *Facts*. The facts are the same as in *Example 7* of this paragraph (g), except that on April 30, 2016, FA transfers $5.5x of the FT disregarded specified stock to USP in exchange for $5.5x of cash.

(ii) *Results*. After the transfer, FT ceases to be a foreign related person (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(2) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer the $6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $6x of DT deemed instruments that FA is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code and $5.5x of which is transferred to USP. The remaining $0.5x of the specified stock continues to be treated as owned by FA for all purposes of the Code.

*Example 10*. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FA transfers $5x of the FT disregarded specified stock that it acquired on February 1, 2015 to DS, a domestic corporation wholly owned by DT, in exchange for $5x of cash.

(ii) *Results*. After the transfer, FT remains a foreign related person because DS is wholly owned by DT. Therefore, paragraph (d)(2) of this section does not apply. Furthermore, the $5x of FT disregarded specified stock is not, as a result of the transfer, held by a person that is not a foreign related person, a specified related person, or an expatriated entity. Therefore, paragraph (d)(3) of this section does not apply. Because FA, a specified related person, directly transferred disregarded specified stock of FT in a transaction to which paragraphs (d)(2) and (3) of this section do not apply, under paragraph (d)(4) of this section, FA is treated as transferring the $5x of deemed instruments of DT allocable to the $5x of in-group transferred disregarded specified stock ($6x x ($5x/$6x)) to DS.

*Example 11*. (i) *Facts*. On February 1, 2015, FS acquires $6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $6x of cash. The $6x of FT stock is specified stock, and the transaction is recharacterized under paragraph (c)(2) of this section. See *Example 1* of this paragraph (g). On April 30, 2016, FA transfers stock of FS representing 60% of the total voting power and value of the stock of FS to USP, a domestic corporation that is not an expatriated entity. As a result of the transfer, FS ceases to be a foreign related person.

(ii) *Results*. After the February 1, 2015 transfer, FT remains a foreign related person because the FT stock is acquired by FS, a foreign related person with respect to DT at that time. Therefore, paragraph (d)(2) of this section does not apply. However, after the March 1, 2015 transfer, because FS ceases to be a foreign related person, it ceases to be a specified related person. Furthermore, the $6x of disregarded specified stock held before the transaction continues to be held by FS after the transaction, and therefore is not held by a foreign related person, a specified related person, or an expatriated entity after the transaction. Accordingly, under paragraph (d)(3) of this section, immediately before the transfer of FS disregarded specified stock, DT is deemed to transfer $6x ($6x x ($6x/$6x)) of the FT deemed issued stock that it is treated as owning to FS, the specified related person, in redemption of $6x ($6x x ($6x/$6x)) of the DT deemed instruments that FS is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FS is deemed recapitalized into disregarded specified stock actually held by FS, which thereafter is treated as owned by FS for all purposes of the Code, including after the transfer of 60% of the FS stock to USP.

*Example 12*. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FP, a foreign corporation that is not a foreign related person acquires $15x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $15x of cash.

(ii) *Results*. After the transaction, FT ceases to be a foreign related person. Therefore, under paragraph (d)(2) of this section, immediately before the issuance of FT stock to FP, DT is deemed to transfer the $6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $6x of DT deemed instruments that FA is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which thereafter is treated as owned by FA for all purposes of the Code.

*Example 13*. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FS acquires $4x of the FT stock owned by DT in exchange for $4x of cash in a fully taxable transaction. DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FS.

(ii) *Results*. (A) The transfer of FT stock by DT to FS is a specified transaction, but it is not recharacterized under paragraphs (c)(1) and (3) of this section because the exception in paragraph (b)(2)(ii) of this section applies. See *Example 4* of this paragraph (g).

(B) After the transfer, FT remains a foreign related person. Therefore, paragraph (d)(2) of this section does not apply. The disregarded specified stock of FT is not, as a result of the transfer, held by a person that is not a foreign related person, a specified related person, or an expatriated entity. Therefore, paragraph (d)(3) of this section does not apply. There has been no direct transfer of specified stock. Therefore, paragraph (d)(4) of this section also does not apply.

(C) Under paragraph (d)(1) of this section, the $6x of deemed issued stock treated as owned by DT as a result of the specified transaction in which FA acquired FT stock continues to be treated as owned by DT, and the $6x of deemed instruments treated as issued by DT to FA continue to be treated as owned by FA.

(h) *Applicability date*. Except as otherwise provided in this paragraph (h), this section applies to specified transactions completed on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (b)(2)(ii)(A)(*2*) of this section applies to specified transactions completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. Paragraphs (d) and (f)(5), (7), and (10) of this section apply to specified transactions completed on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraphs (d) and (f)(5), (7), and (10) of this section to specified transactions completed before April 4, 2016. In addition, for inversion transactions completed on or after September 22, 2014, in lieu of applying paragraphs (d) and (f)(5) and (7) of this section to specified transactions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to apply the principles of § 1.7701(l)–3(c)(3)(iii). Furthermore, for inversion transactions completed on or after September 22, 2014, in lieu of applying paragraph (f)(10) of this section to specified transactions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to define a section 958(a) U.S. shareholder as a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock in the expatriated foreign subsidiary, but only if such United States shareholder is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person.

(i) *Expiration date*. The applicability of this section expires on or before April 4, 2019.

Par. 11. Section 1.7874–1 is amended by:

1. Adding paragraph (c)(2)(iii).
2. Redesignating paragraphs (f) and (g) as paragraph (g) and (h).
3. Adding paragraph (f).
4. Further redesignating newly redesignated paragraph (h) as paragraph (h)(1).
5. Adding a paragraph heading for newly redesignated paragraph (h) and revising the paragraph heading of newly redesignated paragraph (h)(1).
6. Removing the language "in this paragraph" in the first sentence of newly redesignated paragraph (h)(1).
7. Adding paragraph (h)(2).

The additions and revision read as follows:

*§ 1.7874–1 Disregard of affiliate-owned stock.*

* * * * *

(c) * * *

(2) * * *

(iii) [Reserved]. For further guidance, see § 1.7874–1T(c)(2)(iii).

* * * * *

(f) [Reserved]. For further guidance, see § 1.7874–1T(f).

* * * * *

(h) *Applicability dates*—(1) *In general*. * * *

(2) [Reserved]. For further guidance, see § 1.7874–1T(h)(2).

Par. 12. Section 1.7874–1T is added to read as follows:

*§ 1.7874–1T Disregard of affiliate-owned stock (temporary).*

(a) through (c)(2)(ii) [Reserved]. For further guidance, see § 1.7874–1(a) through (c)(2)(ii).

(iii) *Special rule*. If § 1.7874–6T(c)(2) applies for purposes of applying section 7874(c)(2)(A) and § 1.7874–1, then, for purposes of § 1.7874–1(c)(2) (and so much of § 1.7874–1(c)(1) as relates to § 1.7874–1(c)(2)), the determination of the EAG after the acquisition, as well as the determination of stock held by one or more members of the EAG after the acquisition, is made without regard to one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the acquisition, of stock of the acquiring foreign corporation by one or more members of the foreign-parented group described in § 1.7874–6T(c)(2)(i).

(c)(3) through (e) [Reserved]. For further guidance, see § 1.7874–1(c)(3) through (e).

(f) *Treatment of transactions related to the acquisition*. Except as provided in paragraph (c)(2)(iii) of this section, all transactions that are related to an acquisition are taken into account in applying this section and § 1.7874–1.

(g) through (h)(1) [Reserved]. For further guidance, see § 1.7874–1(g) through (h)(1).

(2) *Applicability date of certain provisions of this section*. Except as provided in this paragraph (h)(2), paragraph (c)(2)(iii) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. Except as provided in this paragraph (h)(2), paragraph (f) of this section applies to domestic entity acquisitions completed on or after September 22, 2014. For domestic entity acquisitions completed before April 4, 2016, however, taxpayers may elect to consistently apply paragraphs (c)(2)(iii) and (f) of this section, and § 1.7874–6T(c)(2), (d)(2), and (f)(2)(ii).

(i) *Expiration date*. This section expires on April 4, 2019.

Par. 13. Section 1.7874–2 is amended by:

1. Revising paragraph (a).
2. Revising the introductory text of paragraph (b).
3. Removing paragraphs (b)(2) through (4).
4. Redesignating paragraphs (b)(5) through (9) as paragraphs (b)(2) through (6), respectively.
5. Adding paragraphs (b)(7) through (13).
6. Revising paragraph (c)(2).
7. Adding paragraph (c)(4).
8. Revising the introductory text of paragraph (f)(1).
9. Adding paragraph (f)(1)(iv).
10. Adding *Example 21* to paragraph (k)(2).
11. Redesignating paragraph (l) as paragraph (l)(1).
12. Adding a paragraph heading for paragraph (l) and revising the heading of newly redesignated paragraph (l)(1).
13. Adding paragraph (l)(2).
14. For each paragraph listed in the following table, removing the language in the "Remove" column and adding in its place the language in the "Add" column:

| *Paragraph* | *Remove* | *Add* |
|---|---|---|
| Newly redesignated (b)(6) | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition |
| (d) | an acquisition described in section 7874(a)(2)(B)(i) | a domestic entity acquisition |
| (e) | acquisitions described in section 7874(a)(2)(B)(i) | domestic entity acquisitions |
| (e) | former shareholders | former domestic entity shareholders |
| (e) | former partners | former domestic entity partners |
| (g)(2)(i) | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition |
| (g)(2)(ii) | acquisition | domestic entity acquisition |
| (g)(6) | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition |
| (h)(3)(i) and (ii) and (h)(4)(ii) | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition |
| (i)(2)(i) and (ii) | an acquisition described in section 7874(a)(2)(B)(i) | a domestic entity acquisition |
| (j)(1) and (3) | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition |
| (k)(2), *Examples 7*, *11*, *13*, *19*, *20* | former shareholders | former domestic entity shareholders |
| (k)(2), *Examples 12*, *14*, *15*, and *16* | acquisition | domestic entity acquisition |
| (k)(2), *Example 19* | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition |
| (l) | acquisitions | domestic entity acquisitions |

The revisions and additions read as follows:

*§ 1.7874–2 Surrogate foreign corporation.*

(a) [Reserved]. For further guidance, see § 1.7874–2T(a).

(b) *Definitions and special rules*. In addition to the definitions in § 1.7874–12T, the following definitions and special rules apply for purposes of this section.

* * * * *

(b)(7) through (13) [Reserved]. For further guidance, see § 1.7874–2T(b)(7) through (13).

(c) * * *

(2) [Reserved]. For further guidance, see § 1.7874–2T(c)(2).

* * * * *

(4) [Reserved]. For further guidance, see § 1.7874–2T(c)(4).

* * * * *

(f) * * *

(1) introductory text [Reserved]. For further guidance, see § 1.7874–2T(f)(1) introductory text.

* * * * *

(iv) [Reserved]. For further guidance, see § 1.7874–2T(f)(1)(iv).

* * * * *

(k) * * *

(2) * * *

*Example 21* [Reserved]. For further guidance, see § 1.7874–2T(k)(2), *Example 21*.

(l) *Applicability date*—(1) *In general*. * * *

(2) [Reserved]. For further guidance, see § 1.7874–2T(l)(2).

Par. 14. Section 1.7874–2T is added to read as follows:

*§ 1.7874–2T Surrogate foreign corporation (temporary).*

(a) *Scope*. This section provides rules for determining whether a foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B). Paragraph (b) of this section provides definitions and special rules. Paragraph (c) of this section provides rules to determine whether a foreign corporation has acquired properties held by a domestic corporation (or a partnership). Paragraph (d) of this section provides rules that apply when two or more foreign corporations complete, in the aggregate, a domestic entity acquisition. Paragraph (e) of this section provides rules that apply when, pursuant to a plan, a single foreign corporation completes more than one domestic entity acquisition. Paragraph (f) of this section provides rules to identify the stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership). Paragraph (g) of this section provides rules that treat certain publicly traded foreign partnerships as foreign corporations for purposes of section 7874. Paragraph (h) of this section provides rules concerning the treatment of certain options (or similar interests) for purposes of section 7874. Paragraph (i) of this section provides rules that treat certain interests (including debt, stock, or a partnership interest) as stock of a foreign corporation for purposes of section 7874. Paragraph (j) of this section provides rules concerning the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b). Paragraph (k) of this section provides examples that illustrate the rules of this section. Paragraph (l) of this section provides the applicability dates of this section, and paragraph (m) provides the date of expiration. For additional definitions that apply for purposes of this section, see § 1.7874–12T.

(b) through (b)(6) [Reserved]. For further guidance, see § 1.7874–2(b) through (b)(6).

(7) A *former initial acquiring corporation shareholder* of an initial acquiring corporation means any person that held stock in the initial acquiring corporation before the subsequent acquisition, including any person that holds stock in the initial acquiring corporation both before and after the subsequent acquisition.

(8) An *initial acquisition* means, with respect to a subsequent acquisition, a domestic entity acquisition occurring, pursuant to a plan that includes the subsequent

acquisition (or a series of related transactions), before the subsequent acquisition.

(9) An *initial acquiring corporation* means, with respect to an initial acquisition, the foreign acquiring corporation.

(10) A *subsequent acquisition* means, with respect to an initial acquisition, a transaction occurring, pursuant to a plan that includes the initial acquisition (or a series of related transactions), after the initial acquisition in which a foreign corporation directly or indirectly acquires (within the meaning of paragraph (c)(4)(ii) of this section) substantially all of the properties held directly or indirectly by the initial acquiring corporation.

(11) A *subsequent acquiring corporation* means, with respect to a subsequent acquisition, the foreign corporation that directly or indirectly acquires substantially all of the properties held directly or indirectly by the initial acquiring corporation.

(12) *Special rule regarding initial acquisitions*. With respect to an initial acquisition, the determination of the ownership percentage described in section 7874(a)(2)(B)(ii) is made without regard to the subsequent acquisition and all related transactions occurring after the subsequent acquisition.

(13) *Special rule regarding subsequent acquisitions*. With respect to a subsequent acquisition (or a similar acquisition under the principles of paragraph (c)(4)(i) of this section) that is an inversion transaction, the applicable period begins on the first date that properties are acquired as part of the initial acquisition.

(c) through (c)(1) [Reserved]. For further guidance, see § 1.7874–2(c) through (c)(1).

(2) *Acquisition of stock of a foreign corporation*. Except as provided in paragraph (c)(4) of this section, an acquisition of stock of a foreign corporation that owns directly or indirectly stock of a domestic corporation (or an interest in a partnership) shall not constitute an indirect acquisition of any properties held by the domestic corporation (or the partnership). See *Example 4* of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(2).

(3) [Reserved]. For further guidance, see § 1.7874–2(c)(3).

(4) *Multiple-step acquisitions*—(i) *Rule*. A subsequent acquisition is treated as a domestic entity acquisition, and the subsequent acquiring corporation is treated as a foreign acquiring corporation. See *Example 21* of paragraph (k) of this section for an illustration of this rule. See also paragraph (f)(1)(iv) of this section (treating certain stock of the subsequent acquiring corporation as stock of a foreign corporation that is held by reason of holding stock of, or a partnership interest in, the domestic entity).

(ii) *Acquisition of property pursuant to a subsequent acquisition*. In determining whether a foreign corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an initial acquiring corporation, the principles of section 7874(a)(2)(B)(i) apply, including § 1.7874–2(c) other than § 1.7874–2(c)(2). For this purpose, the principles of § 1.7874–2(c)(1), including § 1.7874–2(b)(5), apply by substituting the term "foreign" for "domestic" wherever it appears.

(iii) *Additional related transactions*. If, pursuant to the same plan (or a series of related transactions), a foreign corporation directly or indirectly acquires (under the principles of paragraph (c)(4)(ii) of this section) substantially all of the properties directly or indirectly held by a subsequent acquiring corporation in a transaction occurring after the subsequent acquisition, then the principles of paragraph (c)(4)(i) of this section apply to such transaction (and any subsequent transaction or transactions occurring, pursuant to the plan (or the series of related transactions)).

(d) through (f) introductory text [Reserved]. For further guidance, see § 1.7874–2(d) through (f) introductory text.

(1) *Certain transactions*. For purposes of section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) includes, but is not limited to, the stock described in paragraphs (f)(1)(i) through (iv) of this section.

(f)(1)(i) through (f)(1)(iii) [Reserved]. For further guidance, see § 1.7874–2(f)(1)(i) through (iii).

(iv) Stock of a subsequent acquiring corporation received by a former initial acquiring corporation shareholder pursuant to a subsequent acquisition in exchange for, or with respect to, stock of an initial acquiring corporation that is held by reason of holding stock of, or a partnership interest in, a domestic entity.

(g) through (k)(2), *Example 20* [Reserved]. For further guidance, see § 1.7874–2(g) through (k)(2), *Example 20*.

*Example 21. Application of multiple-step acquisition rule*—(i) *Facts*. Individual A owns all 70 shares of stock of DC1, a domestic corporation. Individual B owns all 30 shares of stock of F1, a foreign corporation that is subject to tax as a resident of Country X. Pursuant to a reorganization described in section 368(a)(1)(D), DC1 transfers all of its properties to F1 solely in exchange for 70 newly issued voting shares of F1 stock (DC1 acquisition) and distributes the F1 stock to Individual A in liquidation pursuant to section 361(c)(1). Pursuant to a plan that includes the DC1 acquisition, F2, a newly formed foreign corporation that is also subject to tax as a resident of Country X, acquires 100 percent of the stock of F1 solely in exchange for 100 newly issued shares of F2 stock (F1 acquisition). After the F1 acquisition, Individual A owns 70 shares of F2 stock, Individual B owns 30 shares of F2 stock, F2 owns all 100 shares of F1 stock, and F1 owns all the properties held by DC1 immediately before the DC1 acquisition. In addition, the form of the transaction is respected for U.S. federal income tax purposes.

(ii) *Analysis*—(A) The DC1 acquisition is a domestic entity acquisition, and F1 is a foreign acquiring corporation, because F1 directly acquires 100 percent of the properties of DC1. In addition, the 70 shares of F1 stock received by A pursuant to the DC1 acquisition in exchange for Individual A's DC1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the DC1 acquisition.

(B) The DC1 acquisition is also an initial acquisition because it is a domestic entity acquisition that, pursuant to a plan that includes the F1 acquisition, occurs before the F1 acquisition (which, as described in paragraph (ii)(C) of this *Example 21*, is a subsequent acquisition). Thus, F1 is the initial acquiring corporation.

(C) The F1 acquisition is a subsequent acquisition because it occurs, pursuant to a plan that includes the DC1 acquisition, after the DC1 acquisition and, pursuant to the F1 acquisition, F2 acquires 100 percent of the stock of F1 and therefore is treated under paragraph (c)(4)(ii) of this section (which applies the principles of section 7874(a)(2)(B)(i) with certain modifications) as indirectly acquiring substantially all of the properties held directly or indirectly by F1. Thus, F2 is the subsequent acquiring corporation.

(D) Under paragraph (c)(4)(i) of this section, the F1 acquisition is treated as a domestic entity acquisition, and F2 is treated as a foreign acquiring corporation. In addition, under paragraph (f)(1)(iv) of this section, the 70 shares of F2 stock received by Individual A (a former initial acquiring corporation shareholder) pursuant to the F1 acquisition in exchange for Individual A's F1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the F1 acquisition.

(l) through (l)(1) [Reserved]. For further guidance, see § 1.7874–2(l) through (l)(1).

(2) *Applicability date of certain provisions of this section*. Paragraphs (a), (b)(7) through (13), (c)(2) and (4), and (f)(1)(iv) of this section, as well as the introductory text of paragraph (f)(1) and *Example 21* of paragraph (k)(2), apply to domestic entity acquisitions completed on or after April 4, 2016.

(m) *Expiration date*. This section expires on April 4, 2019.

Par. 15. Section 1.7874–3 is amended by:

1. Revising the second sentence of paragraph (a).
2. Revising the introductory text of paragraph (b).
3. Adding paragraph (b)(4).
4. Revising paragraph (d)(10).
5. Redesignating paragraph (f) as paragraph (f)(1).
6. Adding a paragraph heading for paragraph (f) and revising newly redesignated paragraph (f)(1).
7. Adding paragraph (f)(2).

The revisions and additions read as follows:

*§ 1.7874–3 Substantial business activities.*

(a) * * * Paragraph (b) of this section describes the general rule for determining whether the expanded affiliated group has substantial business activities in the relevant foreign country when compared to its total business activities.* * *

(b) *General rule*. The expanded affiliated group will be considered to have substantial business activities in the relevant foreign country after an acquisition described in section 7874(a)(2)(B)(i) when compared to the total business activities of the expanded affiliated group only if, subject to paragraph (c) of this section, each of the requirements of this paragraph (b) are satisfied.

* * * * *

(4) [Reserved]. For further guidance, see § 1.7874–3T(b)(4).

* * * * *

(d) * * *

* * * * *

(10) [Reserved]. For further guidance, see § 1.7874–3T(d)(10).

* * * * *

(f) *Applicability dates*—(1) *General rule*. Except as otherwise provided in paragraph (f)(2) of this section, this section applies to acquisitions that are completed on or after June 3, 2015. For acquisitions completed before June 3, 2015, see § 1.7874–3T as contained in 26 CFR part 1 revised as of April 1, 2016.

(2) [Reserved]. For further guidance, see § 1.7874–3T(f)(2).

Par. 16. Section 1.7874–3T is added to read as follows:

*§ 1.7874–3T Substantial business activities (temporary).*

(a) through (b)(3) [Reserved]. For further guidance, see § 1.7874–3(a) through 1.7874–3(b)(3).

(4) *Tax residence of foreign acquiring corporation*. The foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.

(c) through (d)(9) [Reserved]. For further guidance, see § 1.7874–3(c) through (d)(9).

(10) The term *relevant financial statements* means financial statements prepared consistently for all members of the expanded affiliated group in accordance with either U.S. Generally Accepted Accounting Principles (U.S. GAAP) or the International Financial Reporting Standards (IFRS) used for the expanded affiliated group's consolidated financial statements, but, if, after the acquisition described in section 7874(a)(2)(B)(i), financial statements will not be prepared consistently for all members of the expanded affiliated group in accordance with either U.S. GAAP or IFRS, then, for each member, financial statements prepared in accordance with either U.S. GAAP or IFRS. The relevant financial statements must take into account all items of income generated by all members of the expanded affiliated group for the entire testing period.

(d)(11) through (f)(1) [Reserved]. For further guidance, see § 1.7874–3(d)(11) through (f)(1).

(2) *Paragraphs (b)(4) and (d)(10) of this section*. Paragraph (b)(4) of this section applies to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (d)(10) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. For domestic entity acquisitions completed on or after June 3, 2015, and before April 4, 2016, however, taxpayers may elect to apply paragraph (d)(10) of this section.

(g) *Expiration date*. The applicability of paragraphs (b)(4) and (d)(10) of this section expires on April 4, 2019.

Par. 17. Section 1.7874–4T is amended by:

1. Revising paragraph (d)(1)(i).
2. Revising paragraphs (i)(6) and (i)(7)(iv).
3. In paragraph (j)(7), removing the word "and" at the end of the paragraph.
4. In paragraph (j)(8), removing the period at the end of the paragraph and adding a semicolon in its place.
5. Adding paragraphs (j)(9), (10), and (11) before *Example 1* of paragraph (j).
6. In paragraph (ii) of *Example 1* of paragraph (j), adding a sentence after the fourth sentence.
7. In paragraph (ii) of *Example 2* of paragraph (j), adding a sentence after the fourth sentence.
8. In paragraph (j), redesignating *Example 3* through *Example 8* as *Example 4* through *Example 9*, respectively.
9. Adding *Example 3* to paragraph (j).
10. In paragraph (ii) of newly redesignated *Example 5* of paragraph (j), revising the fourth sentence.
11. For each paragraph listed in following the table, removing the language in the "Remove" column and adding in its place the language in the "Add" column:

| *Paragraph* | *Remove* | *Add* |
|---|---|---|
| (c)(1)(i), last sentence | *Example 5* | *Example 6* |
| (c)(1)(i), last sentence | *Example 7* | *Example 8* |
| (c)(1)(i), last sentence | *Example 8* | *Example 9* |

| Paragraph | Remove | Add |
|---|---|---|
| (c)(1)(ii)(B), second sentence | *Example 5* | *Example 6* |
| (c)(2), last sentence | *Example 3* | *Example 4* |
| (c)(2), last sentence | *Example 6* | *Example 7* |
| (d)(1)(ii), last sentence | *Example 4* | *Example 5* |
| (h), last sentence | *Example 7* | *Example 8* |
| (h), last sentence | *Example 8* | *Example 9* |
| (i)(7)(iii)(C), last sentence | *Example 5* | *Example 6* |
| (j), newly redesignated *Example 4* (iii), first sentence | *Example 3* | *Example 4* |
| (j), newly redesignated *Example 6* (iii), first sentence | *Example 5* | *Example 6* |
| (j), newly redesignated *Example 9* (iii), first sentence | *Example 8* | *Example 9* |

12. Revising paragraph (k)(1).

The revisions and additions read as follows:

*§ 1.7874–4T Disregard of certain stock related to the acquisition (temporary).*

* * * * *

(d) * * *

(1) * * *

(i) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–7T(b) and 1.7874–10T(b), is less than five (by vote and value); and

* * * * *

(i) * * *

(6) *Marketable securities* has the meaning set forth in section 453(f)(2), except that the term "marketable securities" does not include stock of a corporation or an interest in a partnership that becomes a member of the expanded affiliated group that includes the foreign acquiring corporation in a transaction (or series of transactions) related to the acquisition. See *Example 4* of paragraph (j) of this section for an illustration of this paragraph (i)(6).

(7) * * *

(iv) Any other property acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of property described in paragraph (i)(7)(i), (ii), or (iii) of this section. See *Example 2* and *Example 3* of paragraph (j) of this section for illustrations of this paragraph (i)(7)(iv).

* * * * *

(j) * * *

(9) FA, FMS, FS, and FT are tax residents in the same foreign country;

(10) For purposes of determining the ownership fraction, no shares of FA stock are excluded from the denominator pursuant to § 1.7874–7T(b); and

(11) For purposes of determining the ownership fraction, no shares of FA stock are received by former shareholders of DT pursuant to § 1.7874–10T(b).

*Example 1*. * * *

(ii) * * * See also section 7874(c)(4). * * *

*Example 2*. * * *

(ii) * * * Furthermore, even in the absence of paragraph (i)(7)(iv) of this section, the transfer of marketable securities to FT would be disregarded pursuant to section 7874(c)(4). * * *

*Example 3. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874*. (i) *Facts*. DT is a publicly traded corporation. PRS is a foreign partnership that is unrelated to DT. PRS transfers certain business assets (PRS properties) to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. The shareholders of DT transfer all of their DT stock to FA in exchange solely for the remaining 75 shares of FA stock. None of the PRS properties is property described in paragraph (i)(7)(i) through (iii) of this section, but FA acquires the PRS properties with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis*. Under paragraph (i)(7)(iv) of this section, the PRS properties transferred to FA constitute nonqualified property, because FA acquires the PRS properties in a transaction related to the acquisition of the DT stock with a principal purpose of avoiding the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the PRS properties constitute disqualified stock described in paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not apply to reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the PRS properties increases the fair market value of FA's assets by the fair market value of the PRS properties. Accordingly, pursuant to paragraph (b) of this section, the 25 shares of FA stock transferred to PRS in exchange for the PRS properties are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (i)(7)(iv) of this section, the transfer of the PRS properties to FA would be disregarded pursuant to section 7874(c)(4). Therefore, the only FA stock included in the ownership fraction is the FA stock transferred to DT's former shareholders in exchange for their DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

* * * * *

*Example 5*. * * *

(ii) * * * However, without regard to the application of paragraph (b) of this section and §§ 1.7874–7T(b) and 1.7874–10T(b), the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA stock held by Individual A by reason of owning the DT stock, determined under § 1.7874–2(f)(2), over 100 shares of FA stock outstanding after the acquisition). * * *

* * * * *

(k) * * *

(1) Except to the extent provided in this paragraph (k)(1) and paragraph (k)(2) of this section, this section applies to domestic entity acquisitions completed on or after September 17, 2009. Paragraphs (i)(6) and (i)(7)(iv) of this section apply to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (d)(1)(i) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, however, taxpayers may elect to apply paragraph (d)(1)(i) of this section. For domestic entity acquisitions completed

before November 19, 2015, see paragraphs (i)(6) and (i)(7)(iv) of this section as contained in 26 CFR part 1 revised as of April 1, 2016.

* * * * *

Par. 18. Section 1.7874–6T is added to read as follows:

*§ 1.7874–6T Stock transferred by members of the EAG (temporary).*

(a) *Scope*. This section provides rules regarding whether transferred stock is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1. Paragraph (b) of this section sets forth the general rule under which transferred stock is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1. Paragraph (c) of this section provides exceptions to the general rule. Paragraph (d) of this section provides rules regarding the treatment of partnerships, and paragraph (e) of this section provides rules regarding transactions related to the acquisition. Paragraph (f) of this section provides definitions. Paragraph (g) of this section provides examples illustrating the application of the rules of this section. Paragraph (h) of this section provides dates of applicability, and paragraph (i) of this section provides the date of expiration.

(b) *General rule*. Except as provided in paragraph (c) of this section, transferred stock is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1. Transferred stock that is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 is included in the numerator and the denominator of the ownership fraction. See § 1.7874–5T(a).

(c) *Exceptions*. Transferred stock is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 if paragraph (c)(1) or (2) of this section applies. Transferred stock that is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 is excluded from the numerator of the ownership fraction and, depending upon the application of § 1.7874–1(c), may be excluded from the denominator of the ownership fraction. See § 1.7874–1(b) and (c).

(1) *Transfers involving a U.S.-parented group*. This paragraph (c)(1) applies if the following conditions are satisfied:

(i) Before the domestic entity acquisition, the transferring corporation is a member of a U.S.-parented group.

(ii) After the domestic entity acquisition, each of the transferring corporation (or its successor), any person that holds transferred stock, and the foreign acquiring corporation are members of a U.S.-parented group the common parent of which—

(A) Before the domestic entity acquisition, was a member of the U.S.-parented group described in paragraph (c)(1)(i) of this section; or

(B) Is a corporation that was formed in a transaction related to the domestic entity acquisition, provided that, immediately after the corporation was formed (and without regard to any related transactions), the corporation was a member of the U.S.-parented group described in paragraph (c)(1)(i) of this section.

(2) *Transfers involving a foreign-parented group*. This paragraph (c)(2) applies if the following conditions are satisfied:

(i) Before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group.

(ii) After the domestic entity acquisition, the transferring corporation—

(A) Is a member of the EAG; or

(B) Would be a member of the EAG absent one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the domestic entity acquisition, of stock of the foreign acquiring corporation by one or more members of the foreign-parented group described in paragraph (c)(2)(i) of this section.

(d) *Treatment of partnerships*—(1) *Stock held by a partnership*. For purposes of this section, each partner in a partnership, as determined without regard to the application of paragraph (d)(2) of this section, is treated as holding its proportionate share of the stock held by the partnership, as determined under the rules and principles of sections 701 through 777.

(2) *Partnership treated as corporation*. For purposes of this section, if one or more members of an affiliated group, as determined after the application of paragraph (d)(1) of this section, own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership will be treated as a corporation that is a member of the affiliated group.

(e) *Treatment of transactions related to the acquisition*. Except as provided in paragraphs (c)(1)(ii)(B) and (c)(2)(ii)(B) of this section, all transactions that are related to a domestic entity acquisition are taken into account in applying this section.

(f) *Definitions*. In addition to the definitions provided in § 1.7874–12T, the following definitions apply for purposes of this section.

(1) A *foreign-parented group* means an affiliated group that has a foreign corporation as the common parent corporation. A *member of the foreign-parented group* is an entity included in the foreign-parented group.

(2) *Transferred stock*—(i) *In general*. Transferred stock means stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that is received by a transferring corporation and, in a transaction (or series of transactions) related to the domestic entity acquisition, is subsequently transferred.

(ii) *Special rule*. This paragraph (f)(2)(ii) applies in certain cases in which a transferring corporation receives stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that has the same terms as other stock of the foreign acquiring corporation that is received by the transferring corporation in a transaction (or series of transactions) related to the domestic entity acquisition or that is owned by the transferring corporation prior to the domestic entity acquisition (the stock described in this sentence, collectively, *fungible stock*). Pursuant to this paragraph (f)(2)(ii), if, in a transaction (or series of transactions) related to the domestic entity acquisition, the transferring corporation subsequently transfers less than all of the fungible stock, a pro rata portion of the stock subsequently transferred is treated as consisting of stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii). The pro rata portion is based, at the time of the subsequent transfer, on the relative fair market value of the fungible stock that is stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) to the fair market value of all the fungible stock.

(3) A *transferring corporation* means a corporation that is a former shareholder or former partner.

(4) A *U.S.-parented group* means an affiliated group that has a domestic corporation as the common parent corporation. A *member of the U.S.-parented group* is an entity included in the U.S.-parented group, including the common parent corporation.

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

*Example 1. U.S.-parented group exception not available*—(i) *Facts*. USP, a domestic corporation wholly owned by Individual A, owns all the stock of DT, a domestic corporation, as well as other property. The DT stock does not represent substantially all of the property of USP for purposes of section 7874. Pursuant to a reorganization described in section 368(a)(1)(D), USP transfers all the DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to Individual A pursuant to section 361(c)(1).

(ii) *Analysis*. The 100 FA shares received by USP are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under § 1.7874–5T(a), the shares retain their status as such even though USP subsequently distributes the shares to Individual A pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and § 1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section does not apply. Although before the DT acquisition, USP (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent, after the DT acquisition, and taking into account all transactions related to the acquisition, each of USP, Individual A (the person that holds the transferred stock), and FA (the foreign acquiring corporation) are not members of a U.S.-parented group described in paragraph (c)(1)(ii)(A) or (B) of this section. Accordingly, because the 100 FA shares are not treated as held by members of the EAG, those shares are included in the numerator and the denominator of the ownership fraction. Therefore, the ownership fraction is 100/100.

*Example 2. U.S.-parented group exception available*—(i) *Facts*. USP, a domestic corporation wholly owned by Individual A, owns all the stock of USS, a domestic corporation, and USS owns all the stock of FT, a foreign corporation. FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all of its DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to USS in liquidation pursuant to section 361(c)(1). In a transaction after and related to the DT acquisition, USP sells 60 percent of the stock of USS (by vote and value) to Individual B.

(ii) *Analysis*. The 100 FA shares received by FT are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under § 1.7874–5T(a), the shares retain their status as such even though FT subsequently distributes the shares to USS pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and § 1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section applies. The requirement set forth in paragraph (c)(1)(i) of this section is satisfied because before the DT acquisition, FT (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent (the USP group). The requirement set forth in paragraph (c)(1)(ii) of this section is satisfied because after the DT acquisition, and taking into account all transactions related to the acquisition, each of FA (which is both the successor to FT, the transferring corporation, and the foreign acquiring corporation) and USS (the person that holds the transferred stock) are members of a U.S.-parented group of which USS (a member of the USP group before the DT acquisition) is the common parent. Moreover, the DT acquisition qualifies as an internal group restructuring under § 1.7874–1(c)(2). The requirement set forth in § 1.7874–1(c)(2)(i) is satisfied because before the DT acquisition, 80 percent or more of the stock (by vote and value) of DT was held directly or indirectly by USS (the corporation that after the acquisition, and taking into account all transactions related to the acquisition, is the common parent of the EAG). The requirement set forth in § 1.7874–1(c)(2)(ii) is satisfied because after the acquisition, and taking into account all transactions related to the acquisition, 80 percent or more of the stock (by vote and value) of FA (the foreign acquiring corporation) is held directly or indirectly by USS. Therefore, the 100 FA shares are excluded from the numerator, but included in the denominator, of the ownership fraction. Accordingly, the ownership fraction is 0/100.

*Example 3. U.S.-parented group exception available*—(i) *Facts*. USP, a domestic corporation wholly owned by Individual A, owns all the stock of USS, a domestic corporation, and USS owns all the stock of DT, also a domestic corporation. DT owns all the stock of FT, a foreign corporation. The FT stock represents substantially all of the property of DT for purposes of section 7874. Pursuant to a divisive reorganization described in section 368(a)(1)(D), DT transfers all the FT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to USS pursuant to section 361(c)(1). In a related transaction, USS distributes all the FA stock to USP under section 355(c)(1). Lastly, in another related transaction and pursuant to a divisive reorganization described in section 368(a)(1)(D), USP transfers all the stock of USS and FA to DP, a newly formed domestic corporation, in exchange for all the stock of DP and distributes the DP stock to Individual A pursuant to section 361(c)(1).

(ii) *Analysis*. The 100 FA shares received by USS are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under § 1.7874–5T(a), the shares retain their status as such even though USS subsequently transfers the shares to USP. Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and § 1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section applies. The requirement set forth in paragraph (c)(1)(i) of this section is satisfied because before the DT acquisition, USS (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent (the USP group). The requirement set forth in paragraph (c)(1)(ii) of this section is satisfied because after the DT acquisition, and taking into account all transactions related to the acquisition, each of USS, DP (the person that holds the transferred stock) , and FA (the foreign acquiring corporation) are members of a U.S.-parented group of which DP (a corporation that was formed in a transaction related to the DT acquisition and that, immediately after it was formed (but without regard to any related transactions) was a member of the USP group) is the common parent. Therefore, the 100 FA shares are excluded from the numerator and the denominator of the ownership fraction. Accordingly, the ownership fraction is 0/0.

*Example 4. Foreign-parented group exception*—(i) *Facts*. Individual A owns all the stock of FT, a foreign corporation, and FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all the stock of DT to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to Individual A in liquidation pursuant to section 361(c)(1).

(ii) *Analysis*. The 100 FA shares received by FT are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under § 1.7874–5T(a), the shares retain their status as such even though FT subsequently distributes the shares to Individual A pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG of purposes of applying section 7874(a)(2)(A) and § 1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and § 1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The foreign-parented group exception described in paragraph (c)(2) of this section applies. The requirement set forth in paragraph (c)(2)(i) of this section is satisfied because before the DT acquisition, FT (the transferring corporation) and DT are members of the foreign-parented group of which FT is the common parent. The requirement set forth in paragraph (c)(2)(ii) of this section is satisfied because after the acquisition, and taking into account all transactions related to the acquisition, FT would be a member of the EAG absent the distribution of the FA shares pursuant to section 361(c)(1). Moreover, the DT acquisition qualifies as an internal group restructuring under § 1.7874–1(c)(2). The requirement set forth in § 1.7874–1(c)(2)(i) is satisfied because before the acquisition, 80 percent or more of the stock (by vote and value) of DT was held directly or indirectly by FT, the corporation that, without regard to the distribution of the FA shares pursuant to section 361(c)(1), would be common parent of the EAG after the acquisition. See § 1.7874–1T(c)(2)(iii). The requirement set forth in § 1.7874–1(c)(2)(ii) is satisfied because after the acquisition, but without regard to the distribution of the FA shares pursuant to the section 361(c)(1) distribution, FT would directly or indirectly hold 80 percent or more of the stock (by vote and value) of FA (the foreign acquiring corporation). See § 1.7874–1T(c)(2)(iii). Therefore, the 100 FA shares are excluded from the numerator, but included in the denominator, of the ownership fraction. Accordingly, the ownership fraction is 0/100.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this Example 4, except that in a transaction after and related to the DT acquisition, FA issues 200 shares of FA stock to Individual B in exchange for qualified property (within the meaning of § 1.7874–4T(i)(7)). The foreign-parented group exception does not apply because after the acquisition, and taking into account FA's issuance of the 200 FA shares to Individual B, FT would not be a member of the EAG absent FT's distribution of the 100 FA shares pursuant to section 361(c)(1). Accordingly, the 100 FA shares received by FT are not treated as held by a member of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1. As a result, the ownership fraction is 100/300.

(h) *Applicability dates*. Except as otherwise provided in this paragraph (h), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraphs (d)(2) and (f)(2)(ii) of this section apply to domestic entity acquisitions completed on or after April 4, 2016. Taxpayers, however, may elect either to apply paragraph (c)(2) of this section to domestic entity acquisitions completed before September 22, 2014, or to consistently apply paragraphs (c)(2), (d)(2), and (f)(2)(ii) of this section and § 1.7874–1(c)(2)(iii) and (f) to domestic entity acquisitions completed before April 4, 2016.

(i) *Expiration date*. This section expires on April 4, 2019.

Par. 19. Section 1.7874–7T is added to read as follows:

*§ 1.7874–7T Disregard of certain stock attributable to passive assets (temporary).*

(a) *Scope*. This section identifies certain stock of a foreign acquiring corporation that is attributable to passive assets and that is disregarded in determining the ownership fraction. Paragraph (b) of this section sets forth the general rule regarding when stock of a foreign acquiring corporation is excluded from the denominator of the ownership fraction under this section. Paragraph (c) of this section provides a de minimis exception to the application of the general rule of paragraph (b) of this section. Paragraph (d) of this section provides rules for the treatment of partnerships, and paragraph (e) of this section provides rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1. Paragraph (f) of this section provides definitions. Paragraph (g) of this section provides examples illustrating the application of the rules of this section. Paragraph (h) of this section provides dates of applicability, and paragraph (i) of this section provides the date of expiration.

(b) *General rule*. If, on the completion date, more than fifty percent of the gross value of all foreign group property constitutes foreign group nonqualified property, then stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the product of—

(1) The value of the stock of the foreign acquiring corporation, other than stock that is described in section 7874(a)(2)(B)(ii) and stock that is excluded from the denominator of the ownership fraction under either § 1.7874–1(b) or § 1.7874–4T(b); and

(2) The foreign group nonqualified property fraction.

(c) *De minimis ownership*. Paragraph (b) of this section does not apply if—

(1) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–4T(b) and 1.7874–10T(b), is less than five (by vote and value); and

(2) On the completion date, former domestic entity shareholders or former domestic entity partners, as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group.

(d) *Treatment of partnerships*. For purposes of this section, if one or more members of the modified expanded affiliated group own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership is treated as a corporation that is a member of the modified expanded affiliated group.

(e) *Interaction with expanded affiliated group rules*. Stock that is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section is taken into account for purposes of determining whether an entity is a member of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and determining whether an acquisition qualifies as an internal group restructuring or results in a loss of control, as described in § 1.7874–1(c)(2) and (3), respectively. However, such stock is excluded from the denominator of the ownership fraction for purposes of section 7874(a)(2)(B)(ii) regardless of whether it would otherwise be included in the denominator of the ownership fraction as a result of the application of § 1.7874–1(c).

(f) *Definitions*. In addition to the definitions provided in § 1.7874–12T, the following definitions apply for purposes of this section.

(1) *Foreign group nonqualified property*—(i) *General rule*. Foreign group nonqualified property means foreign group property described in § 1.7874–4T(i)(7), other than the following:

(A) Property that gives rise to income described in section 954(h), determined—

(*1*) In the case of property held by a foreign corporation, by substituting the term "foreign corporation" for the term "controlled foreign corporation;" and

(*2*) In the case of property held by a domestic corporation, by substituting the term "domestic corporation" for the term "controlled foreign corporation," without regard to the phrase "other than the United States" in section 954(h)(3)(A)(ii)(I), and without regard to any inference that the tests in section 954(h) should be calculated or determined without taking transactions with customers located in the United States into account.

(B) Property that gives rise to income described in section 954(i), determined by substituting the term "foreign corporation" for the term "controlled foreign corporation."

(C) Property that gives rise to income described in section 1297(b)(2)(A) or (B).

(D) Property held by a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Internal Revenue Code, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business.

(ii) *Special rule*. Foreign group nonqualified property also means any foreign group property that, in a transaction related to the acquisition, is acquired in exchange for other property, including cash, if such other property would be described in paragraph (f)(1)(i) of this section had the transaction not occurred.

(2) *Foreign group property* means any property (including property that gives rise to stock that is excluded from the ownership fraction under § 1.7874–4T(b)) held on the completion date by the modified expanded affiliated group, other than—

(i) Property that is directly or indirectly acquired in the domestic entity acquisition;

(ii) Stock or a partnership interest in a member of the modified expanded affiliated group; and

(iii) An obligation of a member of the modified expanded affiliated group.

(3) *Foreign group nonqualified property fraction* means a fraction calculated with the following numerator and denominator:

(i) The numerator of the fraction is the gross value of all foreign group nonqualified property, other than property received by the expanded affiliated group that gives rise to stock that is excluded from the ownership fraction under § 1.7874–4T(b).

(ii) The denominator of the fraction is the gross value of all foreign group property, other than property received by the expanded affiliated group that gives rise to stock that is excluded from the ownership fraction under § 1.7874–4T(b).

(4) *Modified expanded affiliated group* means, with respect to a domestic entity acquisition, the group described in either paragraph (f)(4)(i) of this section or paragraph (f)(4)(ii) of this section. A *member of the modified expanded affiliated group* is an entity included in the modified expanded affiliated group.

(i) When the foreign acquiring corporation is not the common parent corporation of the expanded affiliated group, the expanded affiliated group determined as if the foreign acquiring corporation was the common parent corporation.

(ii) When the foreign acquiring corporation is the common parent corporation of the expanded affiliated group, the expanded affiliated group.

(g) *Examples*. The following examples illustrate the rules of this section.

*Example 1. Application of general rule*—(i) *Facts*. Individual A owns all 20 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 76 shares of newly issued FA stock (DT acquisition). In a transaction related to the DT acquisition, FA issues 4 shares of stock to Individual A in exchange for Asset A, which has a gross value of $50x. On the completion date, in addition to the DT stock and Asset A, FA holds Asset B, which has a gross value of $150x, and Asset C, which has a gross value of $100x. Assets A and B, but not Asset C, are nonqualified property (within the meaning of § 1.7874–4T(i)(7)). Further, Asset C was not acquired in a transaction related to the DT acquisition.

(ii) *Analysis*. The 4 shares of FA stock issued to Individual A in exchange for Asset A are disqualified stock under § 1.7874–4T(c) and are excluded from the denominator of the ownership fraction pursuant to § 1.7874–4T(b). Furthermore, additional shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section. This is because on the completion date, the gross value of all foreign group property is $300x (the sum of the gross values of Assets A, B, and C), the gross value of all foreign group nonqualified property is $200x (the sum of the gross values of Assets A and B), and thus 66.67% of the gross value of all foreign group property constitutes foreign group nonqualified property ($200x/$300x). Because FA has only one class of stock outstanding, the shares of FA stock that are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section are calculated by multiplying 20 shares of FA stock (100 shares less the 76 shares described in section 7874(a)(2)(B)(ii) and the 4 shares of disqualified stock) by the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is $150x (the gross value of Asset B) and the denominator is $250x (the sum of the gross values of Assets B and C). Accordingly, 12 shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section (20 shares multiplied by $150x/$250x). Thus, a total of 16 shares are excluded from the denominator of the ownership fraction (4 + 12). As a result, the ownership fraction is 76/84.

*Example 2. Application of de minimis exception*—(i) *Facts*. Individual A owns all 96 shares of the sole class of stock of FA, a foreign corporation. Individual B wholly owns DT, a domestic corporation. Individuals A and B are not related. FA acquires all the stock of DT solely in exchange for 4 shares of newly issued FA stock (DT acquisition). On the completion date, in addition to all of the stock of DT, FA holds Asset A, which is nonqualified property (within the meaning of § 1.7874–4T(i)(7)).

(ii) *Analysis*. Without regard to the application of § 1.7874–4T(b) and paragraph (b) of this section, the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA stock held by Individual B by reason of owning the DT stock, determined under § 1.7874–2(f)(2), over 100 shares of FA stock outstanding after the DT acquisition). Furthermore, on the completion date, Individual B owns less than 5% (by vote and value) of the stock of FA and DT (the members of the expanded affiliated group). Accordingly, the de minimis exception in paragraph (c) of this section applies. Therefore, paragraph (b) of this section does not apply and the ownership fraction is 4/100.

*Example 3. Foreign acquiring corporation not common parent of EAG*—(i) *Facts*. FP, a foreign corporation, owns all 85 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). On the completion date, FA, in addition to all of the stock of DT, owns Asset A, which has a gross value of $40x, and Asset B, which has a gross value of $45x. Moreover, on the completion date, in addition to the 85 shares of FA stock, FP owns Asset C, which has a gross value of $10x. Assets A and C, but not Asset B, are nonqualified property (within the meaning of § 1.7874–4T(i)(7)). Further, Asset B was not acquired in a transaction related to the DT acquisition in exchange for nonqualified property.

(ii) *Analysis*. Under paragraph (f)(2) of this section, Assets A and B, but not Asset C, are foreign group property. Although Asset C is held on the completion date by FP, a member of the expanded affiliated group, Asset C is not foreign group property because FP is not a member of the modified expanded affiliated group. This is the case because if the expanded affiliated group were determined based on FA as the common parent corporation, FP would not be a member of such expanded affiliated group (see paragraph (f)(4)(i) of this section). Under paragraph (f)(1) of this section, Asset A, but not Asset B, is foreign group nonqualified property. Therefore, on the completion date, the gross value of all foreign group property is $85x (the sum of the gross values of Assets A and B), and the gross value of all foreign group nonqualified property is $40x (the gross value of Asset A). Accordingly, on the completion date, only 47.06% of the gross value of all foreign group property constitutes foreign group nonqualified property ($40x/$85x). Consequently, paragraph (b) of this section does not apply to exclude any FA stock from the denominator of the ownership fraction.

(h) *Applicability dates*. Except as otherwise provided in this paragraph (h), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraphs (c), (d), and (f)(2) and (4) of this section apply to domestic entity acquisitions completed on or after April 4, 2016. Paragraphs (f)(1)(i)(A)(*2*) and (f)(1)(i)(D) of this section, as well as the portion of paragraph (f)(1)(i)(C) of this section relating to property that gives rise to income described in section 1297(b)(2)(B), apply to domestic entity acquisitions completed on or after November 19, 2015. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, however, taxpayers may elect to apply paragraphs (c), (d), and (f)(2) and (4) of this section. In addition, for domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to apply paragraph (f)(2) of this section by substituting the term "expanded affiliated group" for the term "modified expanded affiliated group." Furthermore, for domestic entity acquisitions completed on or after September 22, 2014, and before November 19, 2015, taxpayers may elect to apply paragraphs (f)(1)(i)(A)(*2*) and (f)(1)(i)(D) of this section, as well as the portion of paragraph (f)(1)(i)(C) of this section relating to property that gives rise to income described in section 1297(b)(2)(B).

(i) *Expiration date*. The applicability of this section expires on April 4, 2019.

Par. 20. Section 1.7874–8T is added to read as follows:

*§ 1.7874–8T Disregard of certain stock attributable to multiple domestic entity acquisitions (temporary).*

(a) *Scope*. This section identifies stock of a foreign acquiring corporation that is disregarded in determining an ownership fraction by value because it is attributable to certain prior domestic entity acquisitions. Paragraph (b) of this section sets forth the general rule regarding the amount of stock of a foreign acquiring corporation that is excluded from the denominator of the ownership fraction by value under this section, and paragraphs (c) through (f) of this section provide rules for determining this amount. Paragraph (g) provides definitions. Paragraph (h) of this section provides examples illustrating the application of the rules of this section. Paragraph (i) of this section provides dates of applicability, and paragraph (j) of this section provides the date of expiration. This section applies after taking into account § 1.7874–2(e).

(b) *General rule*. This paragraph (b) applies to a domestic entity acquisition (relevant domestic entity acquisition) when the foreign acquiring corporation (including a predecessor) has completed one or more prior domestic entity acquisitions. When this paragraph (b) applies, then, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class.

(c) *Computation of excluded amounts*. With respect to each prior domestic entity acquisition and each relevant share class, the excluded amount is the product of—

(1) The total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all redemption testing periods; and

(2) The fair market value of a single share of stock of the relevant share class on the completion date of the relevant domestic entity acquisition.

(d) *Computation of allocable redeemed shares*—(1) *In general*. With respect to each prior domestic entity acquisition and each relevant share class, the allocable redeemed shares, determined separately for each redemption testing period, is the product of the number of redeemed shares during the redemption testing period and the redemption fraction.

(2) *Redemption fraction*. The redemption fraction is determined separately with respect to each prior domestic entity acquisition, each relevant share class, and each redemption testing period, as follows:

(i) The numerator is the total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all prior redemption testing periods.

(ii) The denominator is the sum of—

(A) The number of outstanding shares of the foreign acquiring corporation stock as of the end of the last day of the redemption testing period; and

(B) The number of redeemed shares during the redemption testing period.

(e) *Rules for determining redemption testing periods*—(1) *In general*. Except as provided in paragraph (e)(2) of this section, a redemption testing period with respect to a prior domestic entity acquisition is the period beginning on the day after the completion date of the prior domestic entity acquisition and ending on the day prior to the completion date of the relevant domestic entity acquisition.

(2) *Election to use multiple redemption testing periods*. A foreign acquiring corporation may establish a reasonable method for dividing the period described in paragraph (e)(1) of this section into shorter periods (each such shorter period, a redemption testing period). A reasonable method would include a method based on a calendar convention (for example, daily, monthly, quarterly, or yearly), or on a convention that triggers the start of a new redemption testing period whenever a share issuance occurs that exceeds a certain threshold. In order to be reasonable, the method must be consistently applied with respect to all prior domestic entity acquisitions and all relevant share classes.

(f) *Appropriate adjustments required to take into account share splits and similar transactions*. For purposes of this section, appropriate adjustments must be made to take into account changes in a foreign acquiring corporation's capital structure, including, for example, stock splits, reverse stock splits, stock distributions, recapitalizations, and similar transactions. Thus, for example, in determining the total number of prior acquisition shares with respect to a relevant share class, appropriate adjustments must be made to take into account a stock split with respect to that relevant share class that occurs after the completion date with respect to a prior domestic entity acquisition.

(g) *Definitions*. In addition to the definitions provided in § 1.7874–12T, the following definitions apply for purposes of this section.

(1) A *binding contract* means an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) does not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, does not prevent an instrument from being a binding contract. A tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934, (15 U.S.C. 78n(d)(1)), and Regulation 14D (17 CFR 240.14d–1 through 240.14d–103) and that is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees.

(2) A *relevant share class* means, with respect to a prior domestic entity acquisition, each separate legal class of shares in the foreign acquiring corporation from which prior acquisition shares were issued. See also paragraph (f) of this section (requiring appropriate adjustments in certain cases).

(3) *Total number of prior acquisition shares* means, with respect to a prior domestic entity acquisition and each relevant share class, the total number of shares of stock of the foreign acquiring corporation that were described in section 7874(a)(2)(B)(ii) as a result of that acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied), adjusted as appropriate under paragraph (f) of this section.

(4) A *prior domestic entity acquisition*—(i) *General rule*. Except as provided in this paragraph (g)(4), a prior domestic entity acquisition means, with respect to a relevant domestic entity acquisition, a domestic entity acquisition that occurred within the 36-month period ending on the signing date of the relevant domestic entity acquisition.

(ii) *Exception*. A domestic entity acquisition is not a prior domestic entity acquisition if—

(A) The ownership percentage described in section 7874(a)(2)(B)(ii) with respect to the domestic entity acquisition was less than five (by vote and value); and

(B) The fair market value of the stock of the foreign acquiring corporation that was described in section 7874(a)(2)(B)(ii) as a result of the domestic entity acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied) did not exceed $50 million, as determined on the completion date with respect to the domestic entity acquisition.

(5) A *redeemed share* means a share of stock in a relevant share class that was redeemed (within the meaning of section 317(b)).

(6) A *signing date* means the first date on which the contract to effect the relevant domestic entity acquisition is a binding contract, or if another binding contract to effect a substantially similar acquisition was terminated with a principal purpose of avoiding section 7874, the first date on which such other contract was a binding contract.

(h) *Examples*. The following examples illustrate the rules of this section.

*Example 1. Application of general rule*—(i) *Facts*. Individual A wholly owns DT1, a domestic corporation. Individual B owns all 100 shares of the sole class of stock of FA, a foreign corporation. In Year 1, FA acquires all the stock of DT1 solely in exchange for 100 shares of newly issued FA stock (DT1 acquisition). On the completion date with respect to the DT1 acquisition, the fair market value of each share of FA stock is $1x. In Year 3, FA enters into a binding contract to acquire all the stock of DT2, a domestic corporation wholly owned by Individual C. Thereafter, FA acquires all the stock of DT2 solely in exchange for 150 shares of newly issued FA stock (DT2 acquisition). On the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is $1.50x. FA did not complete the DT1 acquisition and DT2 acquisition pursuant to a plan (or series of related transactions) for purposes of applying § 1.7874–2(e). In addition, there have been no redemptions of FA stock subsequent to the DT1 acquisition.

(ii) *Analysis*. The DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition) because the DT1 acquisition occurred within the 36-month period ending on the signing date with respect to the DT2 acquisition. Accordingly, paragraph (b) of this section applies to the DT2 acquisition. As a result, and because there were no redemptions of FA stock, the excluded amount is $150x (calculated as 100, the total number of prior acquisition shares, multiplied by $1.50x, the fair market value of a single class of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)). In addition, the denominator of the ownership fraction is $375x (calculated as $525x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less $150x, the excluded amount). Therefore, the ownership percentage by value is 60.

*Example 2. Effect of certain redemptions*—(i) *Facts*. The facts are the same as in paragraph (i) of *Example 1* of this paragraph (h), except that in Year 2 FA redeems 50 shares of its stock (the Year 2 redemption).

(ii) *Analysis*. As is the case in paragraph (ii) of *Example 1* of this paragraph (h), the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition), and paragraph (b) of this section thus applies to the DT2 acquisition. Because of the Year 2 redemption, the allocable redeemed shares, and thus the redemption fraction, must be calculated. For this purpose, the redemption testing period is the period beginning on the day after the completion date with respect to the DT1 acquisition and ending on the day prior to the completion date with respect to the DT2 acquisition. The redemption fraction for the redemption testing period is thus 100/200, calculated as 100 (the total number of prior acquisition shares) divided by 200 (150, the number of outstanding shares of FA stock on the last day of the redemption testing period, plus 50, the number of redeemed shares during the redemption testing period), and the allocable redeemed shares for the redemption testing period is 25, calculated as 50 (the number of redeemed shares during the redemption testing period) multiplied by 100/200 (the redemption fraction for the redemption testing period). As a result, the excluded amount is $112.50x, calculated as 75 (100, the total number of prior acquisition shares, less 25, the allocable redeemed shares) multiplied by $1.50x, the fair market value of a single share of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)), and the denominator of the ownership fraction is $337.50x (calculated as $450x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less $112.50x, the excluded amount). Therefore, the ownership percentage by value is 66.67.

*Example 3. Stock split*—(i) *Facts*. The facts are the same as in paragraph (i) of *Example 2* of this paragraph (h), except as follows. After the Year 2 redemption, but before the DT2 acquisition, FA undergoes a stock split and, as a result, each of the 150 shares of FA stock outstanding are converted into two shares (Year 2 stock split). Further, pursuant to the DT2 acquisition, FA acquires all the stock of DT2 solely in exchange for 300 shares of newly issued FA stock. Moreover, on the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is $0.75x.

(ii) *Analysis*. As is the case in paragraph (ii) of *Example 1* of this paragraph (h), the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition), and paragraph (b) of this section thus applies to the DT2 acquisition. In addition, as is the case in paragraph (ii) of *Example 2* of this paragraph (h), the redemption testing period is the period beginning on the day after the completion date with respect to the DT1 acquisition and ending on the day prior to the completion date with respect to the DT2 acquisition. To calculate the redemption fraction, the total number of prior acquisition shares and the number of redeemed shares during the redemption testing period must be appropriately adjusted to take into account the Year 2 stock split. See paragraph (f) of this section. In this case, the appropriate adjustment is to increase the total number of prior acquisition shares from 100 to 200 and to increase the number of redeemed shares during the redemption testing period from 50 to 100. Thus, the redemption fraction for the redemption testing period is 200/400, calculated as 200 (the total number of prior acquisition shares) divided by 400 (300, the number of outstanding shares of FA stock on the last day of the redemption testing period, plus 100, the number of redeemed shares during the redemption testing period), and the allocable redeemed shares for the redemption testing period is 50, calculated as 100 (the number of redeemed shares during the redemption testing period) multiplied by 200/400 (the redemption fraction for the redemption testing period). In addition, for purposes of calculating the excluded amount, the total number of prior acquisition shares must be adjusted from 100 to 200. See paragraph (f) of this section. Accordingly, the excluded amount is $112.50x, calculated as 150 (200, the total number of prior acquisition shares, less 50, the allocable redeemed shares) multiplied by $0.75x, the fair market value of a single class of FA stock on the completion date with respect to the DT2 acquisition). Consequently, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)), and the denominator of the ownership fraction is $337.50x (calculated as $450x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less $112.50x, the excluded amount). Therefore, the ownership percentage by value is 66.67.

(i) *Applicability dates*. This section applies to domestic entity acquisitions completed on or after April 4, 2016, regardless of when a prior domestic entity acquisition was completed.

(j) *Expiration date*. The applicability of this section expires on April 4, 2019.

Par. 21. Section 1.7874–9T is added to read as follows:

*§ 1.7874–9T Disregard of certain stock in third-country transactions (temporary).*

(a) *Scope*. This section identifies certain stock of a foreign acquiring corporation that is disregarded in determining the ownership fraction. Paragraph (b) of this section provides a rule that, in a third-country transaction, excludes from the denominator of the ownership fraction stock in the foreign acquiring corporation held by former shareholders of an acquired foreign corporation by reason of holding certain stock in that foreign corporation. Paragraph (c) of this section defines a third-country transaction, and paragraph (d) of this section provides other definitions. Paragraph (e) of this section provides operating rules. Paragraph (f) of this section provides an example illustrating the application of the rules of this section. Paragraph (g) of this section provides the dates of applicability, and paragraph (h) of this section provides the date of expiration.

(b) *Exclusion of certain stock of a foreign acquiring corporation from the ownership fraction*. When a domestic entity acquisition is a third-country transaction, stock of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (within the meaning of paragraph (e)(4) of this section) is, to the extent the stock otherwise would be included in the denominator of the ownership fraction, excluded from the denominator of the ownership fraction pursuant to this paragraph.

(c) *Third-country transaction*. A domestic entity acquisition is a third-country transaction if the following requirements are satisfied:

(1) The foreign acquiring corporation completes a covered foreign acquisition pursuant to a plan (or series of related transactions) that includes the domestic entity acquisition.

(2) After the covered foreign acquisition and all related transactions are complete, the foreign acquiring corporation is not subject to tax as a resident in the foreign country in which the acquired foreign corporation was subject to tax as a resident before the covered foreign acquisition and all related transactions.

(3) The ownership percentage, determined without regard to the application of paragraph (b) of this section, is at least 60.

(d) *Definitions*. In addition to the definitions provided in § 1.7874–12T, the following definitions apply for purposes of this section.

(1) A *foreign acquisition* means a transaction in which a foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an acquired foreign corporation (within the meaning of paragraph (e)(2) of this section).

(2) An *acquired foreign corporation* means a foreign corporation whose properties are acquired in a foreign acquisition.

(3) *Foreign ownership percentage* means, with respect to a foreign acquisition, the percentage of stock (by vote or value) of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (within the meaning of paragraph (e)(3) of this section).

(4) *Covered foreign acquisition* means a foreign acquisition in which, after the acquisition and all related transactions are complete, the foreign ownership percentage is at least 60.

(e) *Operating rules*. The following rules apply for purposes of this section.

(1) *Acquisition of multiple foreign corporations that are tax residents of the same foreign country*. When multiple foreign acquisitions occur pursuant to a plan (or series of related transactions) and two or more of the acquired foreign corporations were subject to tax as a resident of the same foreign country before the foreign acquisitions and all related transactions, then those foreign acquisitions are treated as a single foreign acquisition and those acquired foreign corporations are treated as a single acquired foreign corporation for purposes of this section.

(2) *Acquisition of properties of an acquired foreign corporation*. For purposes of determining whether a foreign acquisition occurs, the principles of section 7874(a)(2)(B)(i) and § 1.7874–2(c) and (d) (regarding acquisitions of properties of

a domestic entity and acquisitions by multiple foreign corporations) apply with the following modifications:

(i) The principles of § 1.7874–2(c)(1) (providing rules for determining whether there is an indirect acquisition of properties of a domestic entity), including § 1.7874–2(b)(5) (providing rules for determining the proportionate amount of properties indirectly acquired), apply by substituting the term "foreign" for "domestic" wherever it appears.

(ii) The principles of § 1.7874–2(c)(2) (regarding acquisitions of stock of a foreign corporation that owns a domestic entity) apply by substituting the term "domestic" for "foreign" wherever it appears.

(3) *Computation of foreign ownership percentage*. For purposes of determining a foreign ownership percentage, the principles of all rules applicable to calculating an ownership percentage apply (including section 7874(c)(4) and §§ 1.7874–2, 1.7874–2T, 1.7874–4T, 1.7874–5T, and 1.7874–7T) with the following modifications:

(i) Stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) is not taken into account.

(ii) The principles of this section, section 7874(c)(2)(A), and §§ 1.7874–1, 1.7874–6T, 1.7874–8T, and 1.7874–10T do not apply.

(iii) The principles of § 1.7874–7T apply by, in addition to the exclusions listed in § 1.7874–7T(f)(2)(i) through (iii), also excluding from the definition of foreign group property any property held directly or indirectly by the acquired foreign corporation immediately before the foreign acquisition and directly or indirectly acquired in the foreign acquisition.

(4) *Stock held by reason of holding stock in an acquired foreign corporation*. For purposes of determining stock of a foreign acquiring corporation held by reason of holding stock in an acquired foreign corporation, the principles of section 7874(a)(2)(B)(ii) and §§ 1.7874–2(f), 1.7874–2T(f), and 1.7874–5T apply.

(5) *Change in the tax residency of a foreign corporation*. For purposes of this section, a change in a country in which a foreign corporation is subject to tax as a resident is treated as a transaction. Thus, for example, a change in the location of the management and control of an acquired foreign corporation that results in a change in a country in which the acquired foreign corporation is subject to tax as a resident would be treated as a transaction.

(f) *Example*. The following example illustrates the rules of this section.

*Example*. *Third-country transaction*—(i) *Facts*. FA, a newly formed foreign corporation that is subject to tax as a resident of Country Y, acquires all the stock of DT, a domestic corporation that is wholly owned by Individual A, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). Pursuant to a plan that includes the DT acquisition, FA acquires all the stock of FT, a foreign corporation that is subject to tax as a resident of Country X and wholly owned by Individual B, solely in exchange for the remaining 35 shares of newly issued FA stock (FT acquisition).

(ii) *Analysis*. As described in paragraphs (A) through (C) of this *Example*, the requirements set forth in paragraphs (c)(1) through (3) of this section are satisfied and, as result, the DT acquisition is a third-country transaction.

(A) The FT acquisition is a foreign acquisition because, pursuant to the FT acquisition, FA (a foreign corporation) acquires 100 percent of the stock of FT and is thus treated as indirectly acquiring 100 percent of the properties held by FT (an acquired foreign corporation). See § 1.7874–2(c)(1) and paragraph (e)(2) of this section. Moreover, Individual B is treated as receiving 35 shares of FA stock by reason of holding stock in FT. See § 1.7874–2(f)(1)(i) and paragraph (e)(4) of this section. As a result, not taking into account the 65 shares of FA stock held by Individual A (a former domestic entity shareholder), 100 percent (35/35) of the stock of FA is held by reason of holding stock in FT and, thus, the foreign ownership percentage is 100. See paragraph (e)(3) of this section. Accordingly, the FT acquisition is a covered foreign acquisition. Therefore, because the FT acquisition occurs pursuant to a plan that includes the DT acquisition, the requirement set forth in paragraph (c)(1) of this section is satisfied.

(B) The requirement set forth in paragraph (c)(2) of this section is satisfied because, after the FT acquisition and all related transactions, the foreign country in which FA is subject to tax as a resident (Country Y) is different than the foreign country in which FT was subject to tax as a resident (Country X) before the FT acquisition and all related transactions.

(C) The requirement set forth in paragraph (c)(3) of this section is satisfied because, not taking into account paragraph (b) of this section, the ownership fraction is 65/100 and the ownership percentage is 65.

(D) Because the DT acquisition is a third-country transaction, the 35 shares of FA stock held by reason of holding stock in FT are excluded from the denominator of the ownership fraction. See paragraph (b) of this section. As a result, the ownership fraction is 65/65 and the ownership percentage is 100. The result would be the same if instead FA had directly acquired all of the properties held by FT in exchange for FA stock, for example, in a transaction that would qualify for U.S. federal income tax purposes as an asset reorganization under section 368.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this example, except that before the FT acquisition, but in a transaction related to the FT acquisition, FT becomes subject to tax as a resident of Country Y by reincorporating in Country Y. As is the case in paragraph (ii) of this *Example*, the requirements set forth in paragraphs (c)(1) and (3) of this section are satisfied. The requirement set forth in paragraph (c)(2) of this section is satisfied because, after the FT acquisition and any related transactions, the foreign country of which FA is subject to tax as a resident (Country Y) is different than the foreign country of which FT was subject to tax as a resident (Country X) before the FT acquisition and the reincorporation. See paragraph (e)(5) of this section. Accordingly, the DT acquisition is a third-country transaction and the consequences are the same as in paragraph (ii)(D) of this *Example*.

(iv) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example*, except that, instead of FA acquiring all of the stock of FT, FS, a newly formed foreign corporation that is wholly owned by FA and that is subject to tax as a resident of Country X, acquires all the stock of FT solely in exchange for 35 shares of newly issued FA stock (FT acquisition). As a result of the FT acquisition, FS and FA are each treated as indirectly acquiring 100 percent of the properties held by FT. See § 1.7874–2(c)(1)(i) and (iii) and paragraph (e)(2) of this section. Accordingly, each of FS's and FA's indirect acquisition of properties of FT (an acquired foreign corporation) is a foreign acquisition. However, FS's indirect acquisition of FT's properties is not a covered foreign acquisition because no shares of FS stock are held by reason of holding stock in FT; thus, with respect to this foreign acquisition, the foreign ownership percentage is zero. See § 1.7874–2(f) and paragraphs (e)(3) and (4) of this section. FA's indirect acquisition of FT's properties is a covered foreign acquisition because 35 shares of FA stock (the shares received by Individual B) are held by reason of holding stock in FT; thus, the foreign ownership percentage is 100 percent (100/100). See § 1.7874–2(f)(1)(i) and paragraphs (e)(3) and (4) of this section. Accordingly, because the FT acquisition occurs pursuant to a plan that includes the DT acquisition, the requirement set forth in paragraph (c)(1) of this section is satisfied. Further, as is the case in paragraphs (ii)(B) through (C) of this *Example*, the requirements set forth in paragraphs (c)(2) and (3) of this section are satisfied. Therefore, the DT acquisition is a third-country transaction and the consequences are the same as in paragraph (ii)(D) of this *Example*.

(g) *Applicability dates*. Except as otherwise provided in this paragraph (g), this section applies to domestic entity acquisitions completed on or after November 19, 2015. For domestic entity acquisitions completed on or after November 19, 2015, and before April 4, 2016, however, in lieu of applying paragraphs (d)(3) and (4) of this section, taxpayers may elect to define a covered foreign acquisition as a foreign acquisition in which the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign acquisition exceeds 60 percent of the gross value of all foreign group property (as defined in § 1.7874–7T(f)(2), but substituting the term "expanded affiliated group" for the term "modified expanded affiliated group"), but, for this purpose, gross value shall not include any property that is foreign group nonqualified property (as defined in § 1.7874–7T(f)(1)). In addition, for domestic entity acquisitions completed on or after November 19, 2015, and before April 4, 2016, taxpayers may elect to substitute the requirement of paragraph (c)(2) of this section with the requirement that the tax residence of the foreign acquiring corporation is not the same as that of the acquired foreign corporation, as determined before the foreign acquisition and any related transaction.

(h) *Expiration date*. The applicability of this section expires on April 4, 2019.

Par. 22. Section 1.7874–10T is added to read as follows:

*§ 1.7874–10T Disregard of certain distributions (temporary).*

(a) *Scope*. This section identifies distributions made by a domestic entity that are disregarded in determining an ownership fraction. Paragraph (b) of this section provides the general rule that former domestic entity shareholders or former domestic entity partners are treated as receiving additional stock of the foreign acquiring corporation when the domestic entity has made non-ordinary course distributions (NOCDs). Paragraph (c) of this section identifies distributions that, in whole or in part, are outside the scope of this section. Paragraph (d) of this section provides a de minimis exception to the application of the general rule in paragraph (b) of this section. Paragraph (e) of this section provides rules concerning the treatment of distributions made by a predecessor, and paragraph (f) of this section provides rules for identifying a predecessor. Paragraph (g) of this section provides a special rule for certain distributions described in section 355. Paragraph (h) of this section provides definitions. Paragraph (i) of this section provides dates of applicability, and paragraph (j) of this section provides the date of expiration.

(b) *General rule regarding NOCDs*. Except as provided in paragraph (d) of this section, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), former domestic entity shareholders or former domestic entity partners, as applicable, are treated as receiving, by reason of holding stock or partnership interests in a domestic entity, stock of the foreign acquiring corporation with a fair market value equal to the amount of the non-ordinary course distributions (NOCDs), determined as of the date of the distributions, made by the domestic entity during the look-back period. The stock of the foreign acquiring corporation treated as received under this paragraph (b) is in addition to stock of the foreign acquiring corporation otherwise treated as received by the former domestic entity shareholders or former domestic entity partners by reason of holding stock or partnership interests in the domestic entity.

(c) *Distributions that are not NOCDs*. If only a portion of a distribution is an NOCD, section 7874(c)(4) may apply to the remainder of the distribution. This section does not, however, create a presumption that section 7874(c)(4) applies to the remainder of the distribution.

(d) *De minimis exception to the general rule*. Paragraph (b) of this section does not apply if—

(1) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–4T(b) and 1.7874–7T(b), is less than five (by vote and value); and

(2) On the completion date, former domestic entity shareholders or former domestic entity partners, as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group (within the meaning of § 1.7874–4T(i)(3)).

(e) *Treatment of distributions made by a predecessor*. For purposes of this section, a corporation or a partnership (relevant entity), including a domestic entity, is treated as making the following distributions made by a predecessor with respect to the relevant entity:

(1) A distribution made before the predecessor acquisition with respect to the predecessor; and

(2) A distribution made in connection with the predecessor acquisition to the extent the property distributed is directly or indirectly provided by the predecessor. See paragraph (h)(1)(iv) of this section.

(f) *Rules for identifying a predecessor*—(1) *Definition of predecessor*. A corporation or a partnership (tentative predecessor) is a predecessor with respect to a relevant entity if—

(i) The relevant entity completes a predecessor acquisition; and

(ii) After the predecessor acquisition and all related transactions are complete, the tentative predecessor ownership percentage is at least 10.

(2) *Definition of predecessor acquisition*—(i) *In general*. Predecessor acquisition means a transaction in which a relevant entity directly or indirectly acquires substantially all of the properties held directly or indirectly by a tentative predecessor.

(ii) *Acquisition of properties of a tentative predecessor*. For purposes of determining whether a predecessor acquisition occurs, the principles of section 7874(a)(2)(B)(i) apply, including § 1.7874–2(c) other than § 1.7874–2(c)(2) and (4) (regarding acquisitions of properties of a domestic entity), without regard to whether the tentative predecessor is domestic or foreign.

(iii) *Lower-tier entities of a predecessor*. If, before a predecessor acquisition and all related transactions, the predecessor held directly or indirectly stock in a corporation or an interest in a partnership, then, for purposes of this section, the relevant entity is not considered to directly or indirectly acquire the properties held directly or indirectly by the corporation or partnership.

(3) *Definition of tentative predecessor ownership percentage*. Tentative predecessor ownership percentage means, with respect to a predecessor acquisition, the percentage of stock or partnership interests (by value) in a relevant entity held by reason of holding stock or partnership interests in the tentative predecessor. For purposes of computing the tentative predecessor ownership percentage, the following rules apply:

(i) For purposes of determining the stock or partnership interests in a relevant entity held by reason of holding stock or partnership interests in the tentative predecessor, the principles of section 7874(a)(2)(B)(ii) and §§ 1.7874–2(f)(1)(i) through (iii) and 1.7874–5T apply.

(ii) For purposes of determining the stock or partnership interests in a relevant entity included in the numerator of the fraction used to compute the tentative predecessor ownership percentage, the rules of paragraph (f)(3)(i) of this section apply, and all the rules applicable to calculating the numerator of an ownership fraction with respect to a domestic entity acquisition apply, except that—

(A) The principles of section 7874(c)(2)(A) and §§ 1.7874–1 and 1.7874–6T do not apply; and

(B) The principles of paragraph (b) of this section do not apply.

(iii) For purposes of determining stock or partnership interests in a relevant entity included in the denominator of the fraction used to compute the tentative predecessor ownership percentage, the principles of section 7874(a)(2)(B)(ii) and all rules applicable to calculating the denominator of an ownership fraction with respect to a domestic entity acquisition apply, except that—

(A) The principles of section 7874(c)(2)(A) and §§ 1.7874–1 and 1.7874–6T do not apply; and

(B) The principles of §§ 1.7874–4T and 1.7874–7T through 1.7874–9T do not apply.

(g) *Rule regarding direction of a section 355 distribution*. For purposes of this section, if a domestic corporation (distributing corporation) distributes the stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355, and, immediately before the distribution, the fair market value of the stock of the controlled corporation represents more than 50 percent of the fair market value of the stock of the distributing corporation, then, the controlled corporation is deemed, on the date of the distribution, to have distributed the stock of the distributing corporation. The deemed distribution is equal to the fair market value of the stock of the distributing corporation (but not taking into account the fair market value of the stock of the controlled corporation) on the date of the distribution.

(h) *Definitions*. In addition to the definitions provided in § 1.7874–12T, the following definitions apply for purposes of this section.

(1) A *distribution* means the following:

(i) Any distribution made by a corporation with respect to its stock other than—

(A) A distribution to which section 305 applies;

(B) A distribution to which section 304(a)(1) applies; and

(C) Except as provided in paragraphs (h)(1)(iii) and (iv) of this section, a distribution pursuant to section 361(c)(1).

(ii) Any distribution by a partnership.

(iii) In the case of a domestic entity, a transfer of money or other property to the former domestic entity shareholders or former domestic entity partners that is made in connection with the domestic entity acquisition to the extent the money or other property is directly or indirectly provided by the domestic entity.

(iv) In the case of a predecessor, a transfer of money or other property to the former owners of the predecessor that is made in connection with the predecessor acquisition to the extent the money or other property is directly or indirectly provided by the predecessor.

(2) *Distribution history period*—(i) *In general*. Except as provided in paragraph (h)(2)(ii) or (iii) of this section, a distribution history period means, with respect to a look-back year, the 36-month period preceding the start of the look-back year.

(ii) *Formation date less than 36 months but at least 12 months before look-back year*. If the formation date is less than 36 months, but at least 12 months, before the start of a look-back year, then the distribution history period with respect to that look-back year means the entire period, starting with the formation date, that precedes the start of the look-back year.

(iii) *Formation date less than 12 months before look-back year*. If the formation date is less than 12 months before the start of a look-back year, then there is no distribution history period with respect to that look-back year.

(3) *Formation date* means, with respect to a domestic entity, the date that the domestic entity was created or organized, or, if earlier, the earliest date that any predecessor of the domestic entity was created or organized.

(4) *Look-back period* means, with respect to a domestic acquisition, the 36-month period ending on the completion date or, if shorter, the entire period, starting with the formation date, that ends on the completion date.

(5) *Look-back year* means, with respect to a look-back period, the following:

(i) If the look-back period is 36 months, the three consecutive 12-month periods that comprise the look-back period.

(ii) If the look-back period is less than 36 months, but at least 24 months—

(A) The 12-month period that ends on the completion date;

(B) The 12-month period that immediately precedes the period described in paragraph (h)(5)(ii)(A) of this section; and

(C) The period, if any, that immediately precedes the period described in paragraph (h)(5)(ii)(B) of this section.

(iii) If the look-back period is less than 24 months, but at least 12 months—

(A) The 12-month period that ends on the completion date; and

(B) The period, if any, that immediately precedes the period described in paragraph (h)(5)(iii)(A) of this section.

(iv) If the look-back period is less than 12 months, the entire period, starting with the formation date, that ends on the completion date.

(6) *NOCDs* mean, with respect to a look-back year, the excess of all distributions made during the look-back year over the NOCD threshold for the look-back year.

(7) *NOCD threshold* means, with respect to a look-back year, the following:

(i) If the look-back year has at least a 12-month distribution history period, 110 percent of the sum of all distributions made during the distribution history period multiplied by a fraction. The numerator of the fraction is the number of days in the look-back year and the denominator is the number of days in the distribution history period with respect to the look-back year.

(ii) If the look-back year has no distribution history period, zero.

(i) *Applicability date*. Except as otherwise provided in this paragraph (i), this section applies to domestic entity acquisitions completed on or after September 22,

2014. Paragraph (d) of this section applies to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (g) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. For domestic entity acquisitions completed on or after September 22, 2014, and before November 19, 2015, however, taxpayers may elect to apply paragraph (d) of this section. In addition, for domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to determine NOCDs consistently on the basis of taxable years, in lieu of 12-month periods, in a manner consistent with the principles of this section. See paragraph (h)(5) of this section.

(j) *Expiration date*. This section expires on April 4, 2019.

Par. 23. Section 1.7874–11T is added to read as follows:

*§ 1.7874–11T Rules regarding inversion gain (temporary).*

(a) *Scope*. This section provides rules for determining the inversion gain of an expatriated entity for purposes of section 7874. Paragraph (b) of this section provides rules for determining the inversion gain of an expatriated entity. Paragraph (c) of this section provides special rules with respect to certain foreign partnerships in which an expatriated entity owns an interest. Paragraph (d) of this section provides additional definitions. Paragraph (e) of this section provides an example that illustrates the rules of this section. Paragraph (f) of this section provides the applicability dates, and paragraph (g) of this section provides the date of expiration.

(b) *Inversion gain*—(1) *General rule*. Except as provided in paragraphs (b)(2) and (3) of this section, inversion gain includes income (including an amount treated as a dividend under section 78) or gain recognized by an expatriated entity for any taxable year that includes any portion of the applicable period by reason of a direct or indirect transfer of stock or other properties or license of any property either as part of the acquisition described in section 7874(a)(2)(B)(i), or after such acquisition if the transfer or license is to a specified related person.

(2) *Exception for property described in section 1221(a)(1)*. Inversion gain does not include income or gain recognized by reason of the transfer or license, after the acquisition, of property that is described in section 1221(a)(1) in the hands of the transferor or licensor.

(3) *Treatment of partnerships*. Except to the extent provided in paragraph (c) of this section and section 7874(e)(2), inversion gain does not include income or gain recognized by reason of the transfer or license of property by a partnership.

(c) *Transfers and licenses by partnerships*. If a partnership that is a foreign related person transfers or licenses property, a partner of the partnership shall be treated as having transferred or licensed its proportionate share of that property, as determined under the rules and principles of sections 701 through 777, for purposes of determining the inversion gain of an expatriated entity. See section 7874(e)(2) for rules regarding the treatment of transfers and licenses by domestic partnerships and transfers of interests in certain domestic partnerships.

(d) *Definitions*. The definitions provided in § 1.7874–12T apply for purposes of this section.

(e) *Example*. The following example illustrates the rules of this section.

*Example*—(i) *Facts*. On July 1, 2016, FA, a foreign corporation, acquires all the stock of DT, a domestic corporation, in an inversion transaction. When the inversion transaction occurred, DT wholly owned FS, a foreign corporation that is a controlled foreign corporation (within the meaning of section 957(a)). During the applicable period, FS sells to FA property that is not described in section 1221(a)(1) in the hands of FS. Under section 951(a)(1)(A), DT has a $80x gross income inclusion that is attributable to FS's gain from the sale of the property. Under section 960(a)(1), DT is deemed to have paid $20x of the post-1986 foreign income taxes of FS by reason of this income inclusion and includes $20x in gross income as a deemed dividend under section 78. Accordingly, DT recognizes $100x ($80x + $20x) of gross income because of FS's sale of property to FA.

(ii) *Analysis*. Pursuant to section 7874(a)(2)(A), DT is an expatriated entity. Under paragraph (b)(1) of this section, DT's $100x gross income recognized under sections 951(a)(1)(A) and 78 is inversion gain, because it is income recognized by an expatriated entity during the applicable period by reason of an indirect transfer of property by DT (through its wholly-owned CFC, FS) after the inversion transaction to a specified related person (FA). Sections 7874(a)(1) and (e) therefore prevent the use of certain tax attributes (such as net operating losses) to reduce the U.S. tax owed with respect to DT's $100x gross income recognized under sections 951(a)(1)(A) and 78.

(f) *Applicability dates*. Except as otherwise provided in this paragraph (f), this section applies to transfers and licenses of property completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (b) of this section by excluding the phrase "(including an amount treated as a dividend under section 78)" for transfers and licenses of property completed on or after November 19, 2015, and before April 4, 2016.

(g) *Expiration date*. This section expires on April 4, 2019.

Par. 24. Section 1.7874–12T is added to read as follows:

*§ 1.7874–12T Definitions (temporary).*

(a) *Definitions*. Except as otherwise provided, the following definitions apply for purposes of §§ 1.367(b)–4T, 1.956–2T, 1.7701(l)–4T, 1.7874–2, 1.7874–2T, and 1.7874–6T through 1.7874–11T.

(1) An *affiliated group* has the meaning set forth in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears. A *member of the affiliated group* is an entity included in the affiliated group.

(2) The *applicable period* means, with respect to an inversion transaction, the period described in section 7874(d)(1). However, see also § 1.7874–2T(b)(13) in the case of a subsequent acquisition (or a similar acquisition under the principles of § 1.7874–2T(c)(4)(i)) that is an inversion transaction.

(3) The *completion date* means, with respect to a domestic entity acquisition, the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete.

(4) A *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(5) A *domestic entity acquisition* means an acquisition described in section 7874(a)(2)(B)(i).

(6) A *domestic entity* means, with respect to a domestic entity acquisition, a domestic corporation or domestic partnership described in section 7874(a)(2)(B)(i). A reference to a domestic entity includes a

successor to such domestic corporation or domestic partnership, including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381.

(7) An *expanded affiliated group* (or *EAG*) means, with respect to a domestic entity acquisition, an affiliated group that includes the foreign acquiring corporation, determined as of the completion date. A *member of the EAG* is an entity included in the EAG.

(8) An *expatriated entity* means, with respect to an inversion transaction—

(i) The domestic entity; and

(ii) A United States person that, on any date on or after the completion date, is or was related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity.

(9) *Expatriated foreign subsidiary*—(i) *General rule*. Except as provided in paragraph (a)(9)(ii) of this section, an expatriated foreign subsidiary means a foreign corporation that is a CFC and in which an expatriated entity is a United States shareholder.

(ii) *Exception to the general rule*. A foreign corporation is not an expatriated foreign subsidiary if, with respect to the inversion transaction as a result of which the foreign corporation otherwise would be an expatriated foreign subsidiary—

(A) On the completion date, the foreign corporation was both a CFC and a member of the EAG; and

(B) On or before the completion date, the domestic entity was not a United States shareholder with respect to the foreign corporation.

(10) A *foreign acquiring corporation* means, with respect to a domestic entity acquisition, the foreign corporation described in section 7874(a)(2)(B). A reference to a foreign acquiring corporation includes a successor to the foreign acquiring corporation, including a corporation that succeeds to and takes into account amounts with respect to the foreign acquiring corporation pursuant to section 381.

(11) A *foreign related person* means, with respect to an inversion transaction, a foreign person that is related (within the meaning of section 267(b) or 707(b)(1)) to, or under the same common control as (within the meaning of section 482), a person that is an expatriated entity with respect to the inversion transaction.

(12) A *former domestic entity partner* of a domestic entity that is a domestic partnership is any person that held an interest in the partnership before the domestic entity acquisition, including any person that holds an interest in the partnership both before and after the domestic entity acquisition.

(13) A *former domestic entity shareholder* of a domestic entity that is a domestic corporation is any person that held stock in the domestic corporation before the domestic entity acquisition, including any person that holds stock in the domestic corporation both before and after the domestic entity acquisition.

(14) An *interest in a partnership* includes a capital or profits interest.

(15) An *inversion transaction* means a domestic entity acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), taking into account section 7874(a)(3).

(16) A *non-CFC foreign related person* means, with respect to an inversion transaction, a foreign related person that is not an expatriated foreign subsidiary.

(17) The *ownership fraction* means, with respect to a domestic entity acquisition, the ownership percentage described in section 7874(a)(2)(B)(ii), expressed as a fraction.

(18) A *specified related person* means, with respect to an inversion transaction—

(i) A non-CFC foreign related person;

(ii) A domestic partnership in which a non-CFC foreign related person is a partner; and

(iii) A domestic trust of which a non-CFC foreign related person is a beneficiary.

(19) A *United States person* means a person described in section 7701(a)(30).

(20) A *United States shareholder* has the meaning provided in section 951(b).

(b) *Applicability dates*. Except as otherwise provided in this paragraph (b), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraph (a)(8) of this section; the phrase,“ including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381” in paragraph (a)(6) of this section; and the second sentence of paragraph (a)(10) of this section apply to domestic entity acquisitions completed on or after April 4, 2016. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, however, taxpayers, may elect to apply paragraph (a)(8) of this section; the phrase,“ including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381” in paragraph (a)(6) of this section; and the second sentence of paragraph (a)(10) of this section.

(c) *Expiration date*. This section expires on April 4, 2019.

John Dalrymple,
*Deputy Commissioner for Services and Enforcement.*

Approved: March 25, 2016.

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

(Filed by the office of the Federal Register on April 4, 2016, 5:00 p.m., and published in the issue of the Federal Register for April 8, 2016, 81 F.R. 20858)

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## T.D. 9763

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

# Determination of Adjusted Applicable Federal Rates under Section 1288 and the Adjusted Federal Long-Term Rate under Section 382

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations that provide the method to be used to adjust the applicable Federal rates (AFRs) to determine the corresponding rates under section 1288 of the Internal Revenue Code (Code) for tax-exempt obligations (adjusted AFRs) and the method to be used to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382. For tax-exempt obligations, the

regulations affect the determination of original issue discount under section 1273 and of total unstated interest under section 483. In addition, the regulations affect the determination of the limitations under sections 382 and 383 on the use of certain operating loss carryforwards, tax credits, and other attributes of corporations following ownership changes.

DATES: *Effective Date*: These regulations are effective on April 26, 2016.

*Applicability Dates*: For the dates of applicability, see §§ 1.382–12(d) and 1.1288–1(c).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations under section 1288, Jason G. Kurth at (202) 317-6842; concerning the regulations under section 382, William W. Burhop at (202) 317-6847 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

On March 2, 2015, the IRS and the Treasury Department published a notice of proposed rulemaking (REG–136018–13) in the **Federal Register** (80 FR 11141) proposing the method to be used to determine the adjusted AFRs for tax-exempt obligations under section 1288 and the method to be used to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382. No comments were received on the notice of proposed rulemaking. No public hearing was requested or held. Accordingly, this Treasury decision adopts the proposed regulations without substantive change.

**Explanation of Provisions**

The regulations in this Treasury decision provide the new method by which the Treasury Department and the IRS will determine the adjusted AFRs under section 1288 to take into account the tax exemption for interest on tax-exempt obligations (as defined in section 1275(a)(3) and § 1.1275–1(e)). The regulations also provide that the Treasury Department and the IRS will use the new method to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382(f) to take into account differences between rates on long-term taxable and tax-exempt obligations.

Since November 1986, the adjusted Federal long-term rate published under section 382(f)(2) has been equal to the long-term adjusted AFR with annual compounding published under section 1288(b) in the same month. See Rev. Rul. 86–133 (1986–2 CB 59). For calendar months from November 1986 to February 2013, the Treasury Department determined the adjusted Federal long-term rate and each adjusted AFR described in section 1288(b)(1) by multiplying the corresponding AFR by a fraction (the adjustment factor). The numerator of the adjustment factor was a composite yield of the highest-grade tax-exempt obligations available, which are prime, general obligation tax-exempt obligations. The denominator was a composite yield of U.S. Treasury obligations with maturities similar to those of the tax-exempt obligations. Each of the composite yields was measured over a one-month period.

The IRS published Notice 2013–4 (2013–9 IRB 527) on February 25, 2013, requesting comments on possible modifications to the method by which adjusted AFRs and the adjusted Federal long-term rate are determined. The IRS requested comments on these possible modifications because, since the beginning of 2008, market yields of prime, general obligation tax-exempt obligations had sometimes exceeded market yields of comparable U.S. Treasury obligations, causing the adjusted Federal long-term rate and each adjusted AFR to exceed the corresponding AFRs. Adjusted rates that are higher than the corresponding AFRs indicate that the adjustment factor no longer served the purposes of sections 1288(b)(1) and 382(f)(2), which were intended to adjust only for the tax exemption. These rates were also inconsistent with the express intention of Congress that the adjusted Federal long-term rate and the long-term tax-exempt rate be lower than the Federal long-term rate. See 2 H.R. Rep. No. 99–841 (Conf. Rep.), 99th Cong., 2d Sess. II–188 (1986) (1986–3 CB (Vol. 4) 1, 188).

Notice 2013–4 also provided that, until the Treasury Department and the IRS issue further guidance, the adjusted AFRs and the long-term tax-exempt rate would continue to be calculated using the adjustment factor, except that the adjustment factor would equal one (1) for any month in which the adjustment factor would otherwise be greater than one or in which the denominator of the adjustment factor would otherwise be less than or equal to zero.

After reviewing comments received in response to Notice 2013–4, the Treasury Department and the IRS issued a notice of proposed rulemaking (REG–136018–13) proposing the regulations that are adopted in this Treasury decision. The regulations use historical market data to create an appropriate adjustment factor based on individual tax rates. The regulations provide that the adjusted AFRs and the adjusted Federal long-term rate for each month will be determined from the appropriate AFRs for that month using the adjustment factor that results from the following calculation: 100 percent – [(a combined tax rate) x (a fixed percentage)].

The tax rate in the adjustment factor is the sum of the maximum individual rate under section 1 and the maximum individual rate under section 1411 for the month to which the rate applies. The fixed percentage is the amount by which that combined tax rate must be multiplied to reflect the historical relationship between the maximum tax rate and the spread between yields of taxable and tax-exempt obligations. The fixed percentage in the adjustment factor is 59 percent, because the yield on tax-exempt obligations from February 1986 to July 2007 was lower than that of comparable taxable obligations by, on average, 59 percent of the maximum individual rate in effect under section 1.

Therefore, the adjustment factor under current tax rates would be 74.39 percent, the result of subtracting 25.61 percent (the product of 43.4 percent (the sum of the current maximum individual rate under section 1 (39.6 percent) and the current maximum individual rate under section 1411 (3.8 percent)) and 59 percent) from 100 percent. If an AFR for a given month were 5 percent, under current tax rates, the corresponding adjusted AFR would be 3.72 percent: the product of 74.39 percent and 5 percent. If that 5 percent AFR were the Federal long-term rate for debt instruments with annual compounding, the adjusted Federal long-term rate under section 382 would likewise be 3.72 percent.

As noted previously, because no comments were received on the proposed regulations, the final regulations adopt the proposed regulations without substantive change.

**Effective/Applicability Date**

These regulations apply to determine the adjusted AFRs, adjusted Federal long-term rate, and long-term tax-exempt rate beginning with the rates determined during August 2016 that apply during September 2016.

**Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses. No comments were received.

**Drafting Information**

The principal authors of these regulations are Jason G. Kurth, IRS Office of the Associate Chief Counsel (Financial Institutions and Products) and William W. Burhop, IRS Office of the Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

**Availability of IRS Documents**

The IRS revenue ruling and notice cited in this Treasury decision are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.382–12 also issued under 26 U.S.C. 382(f) and 26 U.S.C. 382(m). * * *

Section 1.1288–1 also issued under 26 U.S.C. 1288(b). * * *

Par. 2. Section 1.382–1 is amended by revising the introductory text and adding an entry for § 1.382–12 to read as follows:

*§ 1.382–1 Table of contents.*

This section lists the captions that appear in the regulations for §§ 1.382–2 through 1.382–12.

* * * * *

*§ 1.382–12 Determination of adjusted Federal long-term rate.*

(a) In general.
(b) Adjusted Federal long-term rate.
(c) Adjustment factor.
(d) Effective/applicability date.

Par. 3. Section 1.382–12 is added to read as follows:

*§ 1.382–12 Determination of adjusted Federal long-term rate.*

(a) *In general*. The long-term tax-exempt rate for an ownership change is the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs. For purposes of the previous sentence, the adjusted Federal long-term rate is the Federal long-term rate determined under section 1274(d) (without regard to paragraphs (2) and (3) thereof), adjusted for differences between rates on long-term taxable and tax-exempt obligations. The Secretary calculates the adjusted Federal long-term rate as provided in paragraph (b) of this section. The Internal Revenue Service publishes the long-term tax-exempt rate and the adjusted Federal long-term rate for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(b) *Adjusted Federal long-term rate*. The adjusted Federal long-term rate for a calendar month is the product of the Federal long-term rate determined under section 1274(d) for that month, based on annual compounding, multiplied by the adjustment factor described in paragraph (c) of this section.

(c) *Adjustment factor*. The adjustment factor is a percentage equal to—

(1) The excess of 100 percent, over

(2) The product of—

(i) 59 percent, and

(ii) The sum of the maximum rate in effect under section 1 applicable to individuals and the maximum rate in effect under section 1411 applicable to individuals for the month to which the adjusted applicable Federal rate applies.

(d) *Effective/applicability date*. The rules of this section apply to the determination of the long-term tax-exempt rate and the adjusted Federal long-term rate beginning with the rates determined during August 2016 that apply during September 2016.

Par. 4. Section 1.1288–1 is added to read as follows:

*§ 1.1288–1 Adjustment of applicable Federal rate for tax-exempt obligations.*

(a) *In general*. In applying section 483 or section 1274 to a tax-exempt obligation, the applicable Federal rate is adjusted to take into account the tax exemption for interest on the obligation. For each applicable Federal rate determined under section 1274(d), the Secretary computes a corresponding adjusted applicable Federal rate by multiplying the applicable Federal rate by the adjustment factor described in paragraph (b) of this section. The Internal Revenue Service publishes the applicable Federal rates and the adjusted applicable Federal rates for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(b) *Adjustment factor*. The adjustment factor is a percentage equal to—

(1) The excess of 100 percent, over

(2) The product of—

(i) 59 percent, and

(ii) The sum of the maximum rate in effect under section 1 applicable to individuals and the maximum rate in effect under section 1411 applicable to individuals for the month to which the adjusted applicable Federal rate applies.

(c) *Effective/applicability date*. The rules of this section apply to the determination of adjusted applicable Federal rates beginning with the rates determined during August 2016 that apply during September 2016.

John Dalrymple
*Deputy Commissioner for Services and Enforcement.*

Approved: April 8, 2016

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

(Filed by the Office of the Federal Register on April 25, 2016, 8:45 a.m., and published in the issue of the Federal Register for April 26, 2016, 81 F.R. 24482)

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# T.D. 9764

## DEPARTMENT OF TREASURY Internal Revenue Service 26 CFR Part 301

## Section 6708 Failure to Maintain List of Advisees With Respect to Reportable Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the penalty under section 6708 of the Internal Revenue Code for failing to make available lists of advisees with respect to reportable transactions. Section 6708 imposes a penalty upon material advisors for failing to make available to the Secretary, upon written request, the list required to be maintained by section 6112 of the Internal Revenue Code within 20 business days after the date of such request. The final regulations primarily affect individuals and entities who are material advisors, as defined in section 6111 of the Internal Revenue Code.

DATES: *Effective Date*: These regulations are effective on April 28, 2016.

*Applicability Date*: For date of applicability see § 301.6708–1(i).

FOR FURTHER INFORMATION CONTACT: Hilary March, (202) 317-5406 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and 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 1545-2245.

The collection of information in the final regulations is in § 301.6708–1(c)(3)(ii). This information is required for the IRS to determine whether good cause exists to allow a person affected by these regulations an extension of the legislatively established 20-business-day period to furnish a lawfully requested list to the IRS. The collection of information is voluntary to obtain a benefit. The likely respondents are persons (individuals and entities) who qualify as material advisors, as defined in section 6111, who are unable to respond to a valid and statutorily authorized section 6112 list request within the statutory period of time provided by section 6708.

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

Books and records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103 of the Internal Revenue Code.

**Background**

This document contains amendments to the Procedure and Administration Regulations (26 CFR Part 301) under section 6708 relating to the penalty for failure by a material advisor to maintain and make available a list of advisees with respect to reportable transactions. On March 8, 2013, a notice of proposed rulemaking (REG–160873–04) relating to the penalty under section 6708 was published in the **Federal Register** (78 FR 14939). A public hearing was scheduled for July 2, 2013. The IRS did not receive any requests to testify at the public hearing, and the hearing was cancelled. Two comments were received in response to the notice of proposed rulemaking. After considering the comments, the Treasury Department and the IRS are adopting the proposed regulations as amended by this Treasury decision. The revisions are discussed elsewhere in this document. Additionally, minor, non-substantive edits were made to the proposed regulations to improve clarity.

**Summary of Comments and Explanation of Revisions**

In response to the notice of proposed rulemaking, the IRS received and considered two comments. Those comments are available for public inspection at *www.regulations.gov* or upon request.

The comments covered ten areas: (1) Delivery of the list request by leaving it at the material advisor's last and usual place of abode or usual place of business; (2) the date the 20-business-day period begins in cases where the list request is mailed to the material advisor; (3) the imposition of the penalty on the day of compliance when the response is untimely; (4) extensions of time for complying with list requests; (5) reasonable cause for failure to furnish lists within the 20-business-day time period in cases where a material advisor's employee violates the material advisor's section 6112 list maintenance procedures; (6) the ordinary business care standard; (7) reliance on an independent tax professional's advice; (8) the accumulation of penalties during the IRS agent's review of an incomplete list where the material advisor fails to establish that it acted in good faith; (9) the examples provided in proposed § 301.6708–1(g) and (h); and (10) administrative review of the imposition of the penalty.

1. *Comments Relating to § 301.6708–1(b)*

As proposed, § 301.6708–1(b) of the regulations provided that the 20-business-day period within which the material advisor must make the list available shall begin on the first business day after the earliest of the date that the IRS (1) mails a list request by certified or registered mail, (2) hands delivers the written list request, or (3) leaves the written list request at the material advisor's last and usual place of abode or usual place of business.

A. Delivery of the List Request by Leaving It at the Material Advisor's Last and Usual Place of Abode or Usual Place of Business

One commenter recommended deleting proposed § 301.6708–1(b)(3), which allows the IRS to leave the written list request at the material advisor's last and usual place of abode or usual place of business, noting that this method of delivery did not appear in the interim guidance issued by the IRS in Notice 2004–80, 2004–2 C.B. 963. The commenter expressed a concern that the list request may be left with a child or another person who fails to deliver it to the material advisor or that it may be left on a door step and lost or destroyed before being discovered by the material advisor. If such an incident were to occur, the material advisor who did not receive a list request would be in the difficult position of proving that they never received the list request to qualify for reasonable cause. The commenter also compared the list request to a notice of deficiency, which is delivered by certified or registered mail, and to collection due process notices, which may be given in person, left at the dwelling or usual business place of the person to whom the notice is addressed, or sent by registered or certified mail. The commenter stated that a list request is more similar to a notice of deficiency than a collection due process notice because it requires affirmative action.

There is an important way in which a list request under section 6112 is dissimilar to a notice of deficiency. A taxpayer who wishes to challenge the determination in a notice of deficiency must file a petition with the United States Tax Court within 90 days of the notice date (150 days if the taxpayer is located outside of the United States). This time period cannot be altered. By contrast, if the IRS leaves the written list request at the material advisor's usual place of business, but the material advisor does not receive the list request despite the exercise of ordinary business care, the material advisor may, depending on all facts and circumstances, qualify for an extension of the 20-business-day period to furnish the list and may have reasonable cause for failing to timely furnish the list for the days the material advisor was unaware a list request had been made.

The provision allowing for delivery of the list request to the material advisor's usual place of business is necessary to facilitate the delivery of a list request. For example, this provision enables the Service to leave a list request with the administrative assistant of the person required to maintain the list. Further, this provision assists in the delivery of a list request to a material advisor who is attempting to evade delivery of the request.

Nonetheless, in light of the commenter's concerns, the final regulations narrow the scope of § 301.6708–1(b). The final regulations provide that a list request may be left at the material advisor's usual place of business and remove the language regarding leaving the list request at the material advisor's place of abode. The final regulations also provide that a list request can only be left with an individual 18 years of age or older.

B. The Date the 20-Business-Day Period Begins in Cases Where the List Request Is Mailed to the Material Advisor

The commenter also objected that, when the IRS mails the list request, the time to comply is shorter than in cases where the request is hand delivered because under § 301.6708–1(b)(1), the 20-business-day period is calculated from the date of mailing. The commenter also expressed a concern that the material advisor may have no way of determining when the IRS mailed the list request. The commenter suggested that the regulation require the list request to state the date of mailing and suggested that the 20-business-day period for making the list available begin the later of three days after the stated date of mailing or, if the material advisor can establish the date of delivery, the date of actual delivery.

With respect to the commenter's concern that the material advisor may not know the date the IRS mailed the list request, IRS employees requesting lists are expected to date the list request with the date it is mailed. Additionally, the list requests are sent by certified mail and the recipient can use the certified mail number to look up the date of mailing if the envelope containing the list request is not itself postmarked with the date of mailing.

Regarding the rule proposed by the commenter, the statutory text of section 6708 itself provides for imposition of the penalty if the material advisor fails to make the list available upon written request "within 20 business days *after the date of such request*." (Emphasis added.) Were the regulations to provide for the 20-business-day period to begin three days after the date the letter was mailed, in some circumstances, the material advisor would receive more than 20 business days in which to respond to the list request.

Where the list request is mailed to the material advisor, the IRS has historically interpreted "the date of such request" to refer to the date of mailing. *See* Notice 2004–80, 2004–2 CB 963. This interpretation is reasonable, particularly given the requirement that material advisors maintain the list in a readily accessible form. The 20-business-day period is sufficient to accommodate normal mailing time and to leave sufficient time after receipt, in ordinary circumstances, for a material advisor to produce a list that has been maintained in a readily accessible form. Adopting the rule suggested by the commenter would complicate the rule to accommodate the unusual circumstance in which the amount of time it took for the material advisor to receive the list request made it impossible for the list to be timely furnished. In such a circumstance, however, the material advisor may, considering all facts and circumstances, be eligible for an extension of the 20-business-day period and may, considering all facts and circumstances, have reasonable cause for not providing the list within the 20-business-day period. Accordingly, this comment was not adopted.

2. *Comment Relating to § 301.6708–1(e)(1) and (2): The Imposition of the Penalty on the Day of Compliance when the Response Is Untimely*

As proposed, the penalty was computed under § 301.6708–1(e)(1) and (2) from the first calendar day after the period for furnishing a list in the form required by section 6112 (either the 20-business-day period following a written list request or the extension period, if extended) until, and including, the day the person's failure ends. One commenter stated that, if the list is furnished after the 20-business-day period, the day that the list is furnished should not be included in the penalty computation. The commenter further explained its interpretation that the language of section 6708(a)(1) providing that the penalty is imposed for "each day of such failure after the 20th day" means that the penalty may not be imposed on the day that the list is furnished to the IRS because on that day there was no failure to respond to the list request.

Section 6708(a)(1) provides:

> If any person who is required to maintain a list under section 6112(a) fails to make such list available upon written request to the Secretary in accordance with section 6112(b) within 20 business days after the date of such request, such person shall pay a penalty of $10,000 for each day of such failure after such 20th day.

The purpose of the section 6708 penalty is to encourage voluntary compliance with the requirement to maintain section 6112 lists and timely provide those lists to the IRS. Penalizing the material advisor on the day of compliance does not significantly promote that purpose. Balancing the purpose of the penalty with the size of this particular penalty warrants adopting the comment in this case. Accordingly, § 301.6708–1(e)(1) of the regulations provides that the day the list was furnished to the IRS will not be included in the calculation of the penalty amount.

3. *Comment Relating to § 301.6708–1(c): Manner of and Extensions of Time for Making a List Available*

Section 301.6708–1(c)(3) of the regulations permits the IRS, in its discretion, to grant an extension of the 20-business-day period upon a showing of good cause. Under the regulations as proposed, any request for an extension had to, among other requirements, state that to the best of the person's knowledge, all information and records relating to the list under that person's possession, custody, or control have been maintained according to procedures and policies consistent with sections 6001 and 6112.

The proposed regulations contained one example illustrating the application of the § 301.6708–1(c)(3) extension provisions. *See* § 301.6708–1(c)(4). The example concerns a large law firm that is a material advisor and has educated its attorneys about the firm's obligations related to reportable transactions. To ensure compliance, the firm has policies in place, under which one professional will notify the firm's compliance officer about any tax engagement involving a reportable transaction and then direct a subordinate to send the documents required to be maintained under section 6112 to the compliance officer. In compiling its section 6112 list after receiving a request from the IRS, the firm discovers that one of its attorneys, who is no longer with the firm, did not provide the documentation required by the firm's policies with respect to one reportable transaction. Because the firm will have to search for responsive documents in its storage facility and contact clients for information, it will not be able to respond to the list request within 20 business days and requests a 10-day extension. In this example, the IRS grants the 10-day extension with respect to the one transaction at issue.

One commenter suggested that the IRS should also grant an extension where one of the firm's professionals failed to disclose one or more reportable transactions in contravention of established firm policy, and as a result, the firm did not know that it was a material advisor with respect to those transactions. In such a situation, the commenter suggested that the firm would need additional time to locate information. The commenter noted that the example in the proposed regulations does not cover such a situation and suggested that an additional example covering this situation be added to the regulation. To eliminate any confusion regarding the scenario posed by the commenter, an additional example addressing the commenter's concern has been added to § 301.6708–1(c)(4).

The commenter also objected to the requirement that a person requesting an extension of the 20-business-day period must state that, to the best of the person's knowledge, all information and records relating to the list under the person's possession, custody, or control have been maintained in accordance with procedures and policies that are consistent with sections 6001 and 6112. To account for the scenario in which one of a firm's professionals has failed to disclose a reportable transaction in contravention of its policy, the commenter suggested that a person should be able to request an extension under § 301.6708–1(c)(3)(ii) either by making the above statement or by providing "a detailed explanation of the procedures such person has in place to comply with the requirements of section 6112, its efforts to adhere to such procedures, and the reasons why the specific information and records sought in the request were not so maintained."

In some situations warranting an extension, including the scenario described by the commenter and the examples set forth in § 301.6708–1(c)(4), the person requesting the extension will not be able to make the statement required by the proposed regulation. For instance, in example one of § 301.6708–1(c)(4), the firm discovers after receiving the list request that a subordinate did not provide the documentation relating to a reportable transaction to the compliance officer, in contravention of the firm's policy. Accordingly, at the time of the extension request, the firm is aware that the records relating to at least one transaction have not been maintained in accordance with its procedures and policies. The firm, therefore, cannot state that all records relating to the list have been maintained in accordance with its list maintenance procedures and policies, as the proposed regulation required. The final regulation is changed so that material advisors can make the statements required by § 301.6708–1(c)(3)(ii) in order to request an extension even if, after receiving a list request, they discover a failure to comply with their list maintenance procedures, as long as, to the best of their knowledge as of the date of the list request, all information and records relating to the list had been maintained in accordance with procedures and policies consistent with sections 6001 and 6112.

The specific language suggested by the commenter, however, is very broad. Persons who are required to maintain a list under section 6112 are required and expected to maintain the list in a readily accessible form. *See* § 301.6112–1(d). To comply with section 6112, ordinary business care requires a person, upon discovering any failure relating to the list, to take immediate steps to correct the failure. The commenter's suggested language could allow an extension to be obtained by a person who became aware of a failure relating to the list prior to a request for the list, but who has not corrected it or has otherwise not exercised ordinary business care or made a good-faith effort to comply with section 6112 by maintaining the list in a readily accessible form.

Therefore, although the specific language suggested by the commenter was not adopted, § 301.6708–1(c)(3)(ii) has been amended as set forth in the regulatory text of this rule to account for the circumstance identified by the commenter.

In addition, language is added to section 301.6708–1(c)(2) to clarify that making the list available through inspection includes allowing the IRS to copy the list. This is consistent with the underlying requirement to furnish the list under section 6112. *See* section 301.6112–1(e)(1) (providing that each component of the list must be furnished to the IRS in a format that enables the IRS to determine without undue delay or difficulty the information required to be included in the list). This clarification is also consistent with case law concluding that inspecting or examining includes copying documents. *See, e.g.*, *Westside Ford, Inc. v. United States*, 206 F.2d 627, 634 (9th Cir. 1953) (holding that the right to inspect documents under 50 U.S.C. 2155(a) includes the right to make copies); *Boren v. Tucker*, 239 F.2d 767, 771–72 (9th Cir. 1956) (holding that the right to examine documents under section 7602 includes the right to make copies); *McGarry v. Riley*, 363 F.2d 421, 424 (1st Cir. 1966) (holding that a court order enforcing a summons under section 7602 necessarily allowed the Service to make copies, regardless of whether the order specifically allowed copying).

4. *Comments Relating to § 301.6708–1(g): Reasonable Cause for Failure to Furnish Lists Within the 20-Business-Day Time Period*

Section 6708(a)(2) provides an exception to the penalty for any day in which the failure to furnish the list is due to reasonable cause. Section 301.6708–1(g) describes reasonable cause for purposes of the section 6708 penalty. Reasonable cause is determined on a case-by-case and day-by-day basis, taking into account all the relevant facts and circumstances. Factors considered in determining the existence of reasonable cause include, but are not limited to, good-faith efforts to comply with section 6112, exercise of ordinary business care, supervening events beyond the person's control, and reliance on an independent tax professional's advice. Section 301.6708–1(g) also provides examples illustrating the application of the reasonable cause provisions.

A. Reasonable Cause Where an Employee of the Material Advisor Violates the Material Advisor's Section 6112 List Maintenance Procedures

One commenter stated that the IRS should find reasonable cause where an employee of the material advisor failed to disclose one or more reportable transactions in contravention of the firm's established list maintenance procedures, and as a result, the firm did not know that it was a material advisor with respect to those transactions. The commenter suggested expanding the illustrations of reasonable cause to include this situation.

Similarly, the other commenter was concerned by a lack of clarity as to how the actions of a material advisor's employees, shareholders, partners, or agents would affect the material advisor's reasonable cause claim when the material advisor is a law firm, accounting firm, or similar entity. The commenter noted that, under § 301.6111–3(b)(2)(iii)(A), these individuals are generally not treated as material advisors, and their tax statements are generally attributed to their employers, corporations, partnerships, or principals. The commenter suggested that proposed § 301.6708–1(g)(3) be revised to clarify that a material advisor may still show reasonable cause even if one or more employees of the material advisor did not exercise ordinary business care and would not have reasonable cause, as long as the material advisor had appropriate procedures in place, the failure represents an isolated incident, and the material advisor acted promptly to correct the error upon learning of the employee's noncompliance. The commenter also suggested adding an example to proposed § 301.6708–1(g) similar to that in proposed § 301.6708–1(c)(4), which states that under the given circumstances, a material advisor should be granted an extension despite a former subordinate's failure to comply with its list maintenance policy.

Proposed § 301.6708–1(g)(3) stated that ordinary business care may be established by showing that the material advisor established and adhered to list maintenance procedures reasonably designed and implemented to ensure compliance with section 6112. Proposed section 301.6708–1(g)(3) also stated that, considering all the relevant facts and circumstances, a material advisor may still be able to demonstrate ordinary business care despite an isolated and inadvertent failure related to the list if the material advisor shows that steps were taken to correct any such failure upon discovery. Section 301.6708–1(g)(3) is intended to capture failures that may be caused by the actions of an individual employee, shareholder, partner, or agent of the material advisor when the material advisor is a law firm or other entity. Depending on the facts and circumstances of the particular case, a material advisor in the situations described by the commenters may be able to establish that it exercised ordinary business care and made good-faith efforts to comply with section 6112, and therefore had reasonable cause under the regulations as already proposed. Accordingly, the comment was not adopted to the extent that it recommended modifying proposed § 301.6708–1(g)(3). To respond to the commenter's concerns, however, a new example 5 has been added to § 301.6708–1(h)(3), in which a material advisor is determined to have reasonable cause despite a former employee's failure to comply with its list maintenance procedures.

B. The Ordinary Business Care Standard

As proposed, § 301.6708–1(g)(3) provides, in relevant part: "The exercise of ordinary business care may constitute reasonable cause. To show ordinary business care, the person may, for example, show that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112." One commenter stated that, absent extraordinary circumstances, establishing and adhering to reasonable compliance procedures should always result in a finding of reasonable cause. The commenter suggested revising the wording of proposed § 301.6708–1(g)(3) to provide that "[t]he exercise of ordinary business care *shall* constitute reasonable cause."

Reasonable cause is determined on a case-by-case and day-by-day basis, taking into account all the relevant facts and circumstances. A material advisor will not be able to establish reasonable cause if the material advisor did not exercise ordinary business care. However, ordinary business care is not the only factor that must be taken into account to determine whether the failure was due to reasonable cause. The wording suggested by the commenter does not acknowledge that the determination of whether a material advisor establishes reasonable cause is based on all relevant facts and circumstances, including not only whether the material advisor exercised ordinary business care in maintaining a readily producible list but also whether the material advisor, upon receiving the list request, tried in good faith to make the list available within the 20-business-day period (or extended period). In fact, the suggested wording would elevate the exercise of ordinary business care above all other facts and circumstances that should be taken into account in determining reasonable cause. Although exercising ordinary business care is important, standing alone, it is not sufficient to demonstrate reasonable cause. Accordingly, this comment was not adopted.

C. Reliance on the Advice of an Independent Tax Professional

Proposed, § 301.6708–1(g)(5) provided in relevant part that a person may rely on the advice of an independent tax professional to establish reasonable cause. One commenter expressed concern that the IRS and courts would interpret this provision in such a way as to presume that a material advisor could not establish reasonable cause if it did not consult with an independent tax professional. The commenter objected to any such presumption on the basis that most material advisors have the necessary background and experience to evaluate their list maintenance obligations without seeking outside advice. The commenter suggested that the proposed regulations be amended to explicitly reject any such presumption.

Under proposed § 301.6708–1(g)(1), the determination of whether a material advisor had reasonable cause is made on a case-by-case and day-by-day basis, taking into account all the relevant facts and circumstances, the most important of which are those that reflect the extent of the person's good-faith efforts to comply with section 6112. Reasonable cause under proposed § 301.6708–1(g)(5) is not conditioned on seeking the advice of an independent tax professional. Rather, that section describes how reliance on an independent tax professional will be taken into account for purposes of determining whether a failure was due to reasonable cause. However, to alleviate the concern and clarify that a material advisor is not required to obtain advice from an independent tax professional to establish reasonable cause, the following sentence has been added to the final regulations under § 301.6708–(g)(5)(i): "Independent tax professional advice is not required to establish reasonable cause, and the failure to obtain advice from an independent tax professional does not preclude a finding of reasonable cause if, based on the totality of all of the relevant facts and circumstances, reasonable cause has been established."

The commenter also suggested supplementing § 301.6708–1(g)(5)(i) with language indicating that reasonable reliance on the advice of an independent tax professional is to be evaluated based on the knowledge and good faith of the individual employee or employees primarily responsible for compliance procedures for the particular transaction at issue, rather than other employees at the firm.

Proposed, § 301.6708–1(g)(5)(i) provided that, to establish reasonable cause, a material advisor's reliance on the advice of an independent tax professional must be reasonable and in good faith, in light of all the other facts and circumstances. While the knowledge and good faith of the individual employees primarily responsible for compliance procedures for the particular transaction is certainly relevant to the determination of whether the material advisor reasonably relied on the advice of an independent tax professional, the knowledge and good faith of those employees' supervisors or other individuals also may be relevant, depending on the specific facts and circumstances. Accordingly, this comment was not adopted.

D. Examples

Proposed section 301.6708–1(g)(6) contains examples illustrating the application of the reasonable cause provisions. *Example 3*, *Example 5*, and *Example 6* of proposed § 301.6708–1(g)(6) reference a particular technology for saving the data to a CD-ROM, and reference sending the paper documents to an off-site storage facility. The examples have been updated to remove any implication that any particular technology is specifically approved or required under the regulations, or that the regulations require storage of original records in both electronic and paper format. These changes are not intended to change the principles illustrated in by these examples.

5. *Comments Relating to § 301.6708–1(h)(2) and (h)(3)*

Section 301.6708–1(h)(2) contains special considerations for determining reasonable cause for the period after the material advisor has furnished a list and before the IRS has informed the material advisor of any identified failures in the list. Section 301.6708–1(h)(3) provides examples illustrating the application of this provision. Some of these examples involve situations where the material advisor has omitted information from the list.

A. Period of IRS Review

Proposed section 301.6708–1(h)(2) provided that if the material advisor establishes that it acted in good faith in its efforts to fully comply with the requirements of section 6112, the material advisor will be deemed to have reasonable cause for the days between when the material advisor furnished the list to the IRS and when the IRS informs the material advisor of any identified failures in the list. If the material advisor does not establish that it acted in good faith, the IRS will not consider the time it takes to review a list as a factor in determining whether the material advisor has reasonable cause for that period. One commenter suggested that the penalty should stop accruing once the list has been furnished to the IRS and a specified reasonable review period has passed. The commenter also stated that the penalty should not start accruing again until the IRS has notified the material advisor that the list appears deficient.

Section 301.6708–1(h)(2) was included in the proposed regulations because a material advisor who has acted in good faith and has produced what it believes to be a complete and timely list has no reason to believe that the list is incomplete until the IRS informs that material advisor of any identified failure. Therefore, for a material advisor who acted in good faith, the proposed regulations provide that no penalty is imposed for the time it takes for the IRS to review the list and inform the material advisor of any identified failure, regardless of the length of time it takes the IRS to complete this process.

The rule in proposed § 301.6708–1(h)(2) is more favorable to material advisors who have acted in good faith than the rule suggested by the commenter. Under the commenter's suggestion, a material advisor who furnished the list in good faith does not get the benefit of being deemed to have reasonable cause for the period of IRS review. However, if the commenter's suggestion is adopted, a material advisor who did not furnish a list in good faith would have reasonable cause for at least some of the time that the IRS is reviewing the list regardless of whether the facts and circumstances support reasonable cause. Consequently, the comment was not adopted.

Nevertheless, the Treasury Department and the IRS are sensitive to the commenter's concerns. In addition, it is in the IRS's interest to review lists furnished by material advisors in a timely manner so that information contained on the lists can be used as intended to assist the IRS in identifying taxpayers who participated in abusive and potentially abusive tax shelters. Therefore, the IRS will take reasonable steps to timely review lists and notify material advisors of identified failures in a timely manner.

B. Omissions From the List

In *Example 1* of proposed § 301.6708–1(h)(3), a supervisor within the material advisor organization carefully reviewed the list before furnishing it to the IRS, and in *Example 3* of proposed § 301.6708–1(h)(3), a supervisor within the material advisor organization did not review the list. One commenter suggested that these examples be modified or supplemented to eliminate what the commenter perceived to be an implication that review of a list by a supervisor within the material advisor organization would reasonably be expected to detect omissions from the list and to specify that a material advisor can demonstrate reasonable cause for omitting a transaction or advisee even if a supervisor's review did not identify the omissions. While agreeing that review of the list before submission to the IRS is appropriate, the commenter stated that this review should not be a factor in determining whether a material advisor had reasonable cause.

The commenter also suggested that in many cases in which a material advisor omits a transaction or advisee from a list, the omission may be due to a mistaken application of the reportable transaction rules or an inadvertent failure. The commenter observed that while three of the examples in proposed § 301.6708–1(g) and (h) involve the omission of specific advisees from a list, none of these examples involves a finding that the material advisor had reasonable cause. The commenter suggested adding an example to either proposed subsection (g) or (h) in which the material advisor had reasonable cause for omitting the transaction or advisee from the list.

In looking at all of the facts and circumstances surrounding a material advisor's efforts to comply with section 6112, review of the list by a supervisor or some other person of authority or experience within the material advisor organization before submission of the list to the IRS is merely one factor to be taken into account to determine whether the material advisor has demonstrated reasonable cause. A failure to detect omissions or other failings in the list does not preclude a finding of reasonable cause. That point is already set forth in *Example 1* of proposed § 301.6708–1(h)(3), in which the supervisor's review of the list did not detect that the material advisor had furnished a draft copy of a tax opinion rather than the final document, but under the facts stated in the example, the material advisor was found to have reasonable cause.

However, to eliminate any confusion and to respond to the concerns expressed by the commenter, a new *Example 5* has been added to § 301.6708–1(h)(3), in which the supervisor's review of the list did not detect that the material advisor had omitted a transaction from the list, and under the facts stated in the example, the material advisor was found to have reasonable cause.

6. *Comment Relating to Administrative Review*

One commenter recommended that the regulations provide for administrative review in IRS Appeals of all issues pertaining to the applicability and amount of the penalty, including whether an extension should have been granted and whether reasonable cause exists, before paying the penalty. There are currently administrative procedures providing material advisors with an opportunity for prepayment review of the penalty by Appeals. *See* IRM 4.32.2.11.7.2. Under those procedures, the material advisor has 30 days from the date of receipt of the notice and demand for payment of the section 6708 penalty to request administrative review by IRS Appeals. A material advisor does not have to pay any portion of the section 6708 penalty as a condition of requesting administrative review. Therefore, because the IRM already provides the material advisor with an opportunity for administrative review of the assessment of the penalty prior to payment, this comment was not adopted.

**Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed 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.

It is hereby certified that the collection of information in these 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 described under the heading "Paperwork Reduction Act" only affects persons who qualify as material advisors as defined in section

6111, who are statutorily required by section 6112 to maintain and furnish the underlying documents and information upon which the collection of information is based, and who are unable to meet the section 6708 statutorily provided period of time for furnishing these documents and information. Moreover, the collection of information is voluntary to receive a benefit and requiring those persons to report the information described above imposes only a minimal burden in time or expense. Therefore, 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 Internal Revenue Code, the notice of proposed rulemaking preceding the final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

**Drafting Information**

The principal author of these regulations is Hilary March of the Office of the Associate Chief Counsel (Procedure and Administration).

**List of Subjects in 26 CFR Part 301**

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

**Amendments to the Regulations**

Accordingly, 26 CFR part 301 is amended as follows:

**PART 301—PROCEDURE AND ADMINISTRATION**

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

■ **Authority:** 26 U.S.C. 7805 * * *

Section 301.6708–1 also issued under 26 U.S.C. 6708 * * *

■ **Par. 2.** Section 301.6708–1 is added to read as follows:

**§ 301.6708–1 Failure to maintain lists of advisees with respect to reportable transactions**.

(a) *In general*. Any person who is required to maintain a list under section 6112 who, upon written request for the list, fails to make the list available to the Secretary within 20 business days after the date of the request shall be subject to a penalty in the amount of $10,000 for each subsequent calendar day on which the person fails to furnish a list containing the information and in the form required by section 6112 and its corresponding regulations. The penalty will not be imposed on any particular day or days for which the person establishes that the failure to comply on that day is due to reasonable cause.

(b) *Calculation of the 20-business-day period*. The 20-business-day period shall begin on the first business day after the earliest of the date that the IRS –

(1) Mails a request for the list required to be maintained under section 6112(a) by certified or registered mail to the person required to maintain the list;

(2) Hand delivers the written request to the person required to maintain the list; or

(3) Leaves the written request with an individual 18 years old or older at the usual place of business of the person required to maintain the list.

(c) *Making a list available*. (1) A person who is required to maintain a list required by section 6112 may make the list available by mailing or delivering it to the IRS within 20 business days after the date of the list request. Section 7502 and the regulations thereunder shall apply to this section.

(2) A person who is required to maintain a list required by section 6112 may also make the list available to the IRS by making it available for inspection and copying during normal business hours, as provided by section 6112, or by another agreed-upon method, on an agreed-upon date that falls within the 20-business-day period following the list request.

(3) *Extension*—(i) *In general*. Upon a showing of good cause by the person prior to the expiration of the 20-business-day period following a list request, the IRS may, in its discretion, agree to extend the period within which to make all or part of the list available. For purposes of this paragraph, "good cause" is shown if the person establishes that the 20-business-day deadline cannot reasonably be met despite diligent efforts by the person to maintain the materials constituting a list and to make that list available to the IRS in the time and manner required by the Secretary under section 6112.

(ii) *Requesting an extension*. Any request for an extension of the 20-business-day period must be made in writing to the person at the IRS who requested the list. The person requesting an extension must briefly describe the information and documents that comprise the list as required by section 6112; explain the circumstances that would warrant additional time; propose a schedule to complete the production of the list; state that to the best of the person's knowledge, as of the date of the list request, all information and records relating to the list under the person's possession, custody, or control had been maintained in accordance with procedures and policies that are consistent with sections 6001 and 6112 of the Internal Revenue Code; and state that the extension request is not being made to avoid the person's list maintenance obligations imposed by section 6112 and its corresponding regulations. The IRS may, in its discretion, grant the person's extension request in full or in part. The IRS will consider whether granting an extension may impair its ability to make a timely assessment against any of the participants in the transaction associated with the requested list. The IRS will not grant an extension if it determines that a significant reason for the extension request is to delay producing the list. A pending extension request by itself does not constitute reasonable cause for purposes of section 6708.

(4) *Examples*. The following examples illustrate paragraph (c)(3)(i) and (ii) of this section. These examples are intended to illustrate how the facts and circumstances in paragraph (c)(3)(i) and (ii) of this section may apply; in any given case, however, all of the facts and circumstances must be analyzed.

*Example 1*. (i) Firm A is a large law firm that is a material advisor. Firm A conducts annual sessions to educate its professionals about reportable transactions and the firm's obligations related to those reportable transactions. Firm A instructs its professionals to provide information on tax engagements that involve reportable transactions and to provide the documents required to be maintained under sections 6001 and 6112 to Firm A's compliance officer for list maintenance purposes. Firm A's policy provides that, for each engagement involving a reportable transaction, one firm professional will send an email to the firm's compliance officer about the engagement and then direct a subordinate to send the documents required to be maintained to the firm's compliance officer. Firm A has policies and procedures in place to monitor compliance with these rules and to address non-compliance.

(ii) Firm A receives a request from the IRS for a section 6112 list. In compiling its list to turn over to the IRS during the 20-business-day period following the list request, Firm A discovers that, with respect to one reportable transaction, a subordinate did not provide the documentation required by Firm A's policy. In addition, Firm A experiences difficulty locating the required documents as both the professional and the subordinate who worked on the matter are no longer employed by Firm A, requiring the firm to undertake an extensive search for the information responsive to the list request. Firm A also seeks the information from the firm's clients. Despite these efforts, Firm A reasonably determined that it will not be able to respond timely to the request. Within the 20-business-day period, Firm A notifies the IRS, in writing, of the difficulties it is experiencing and requests an additional 10 business days to locate and produce the information for this one transaction. Within the 20-business-day period, Firm A makes all other required list information available to the IRS, together with a description of the information that is being searched for, all statements required by these regulations, and a proposed schedule to produce the missing information.

(iii) Under these circumstances, Firm A demonstrated that it could not reasonably make the portion of the list relating to the one transaction available within the 20-business-day period and thus qualified for an extension. Firm A had established policies and procedures reasonably designed and implemented to ensure and monitor compliance with the requirements of section 6112 and address non-compliance. Because the facts and circumstances indicate that Firm A made diligent efforts to maintain the materials constituting the list in a readily accessible form and as otherwise required under section 6112, the requested 10-business-day extension with respect to the portion of the list relating to the one transaction where records were not maintained in accordance with the firm's policies and procedures should be granted.

*Example 2*. (i) Assume the same facts set forth in example one, except that, in the process of compiling the list to comply with the list maintenance request, Firm A first becomes aware that a firm professional did not send an email to the firm's compliance officer about a transaction subject to the list maintenance request and did not direct a subordinate to send to the firm's compliance officer the information required to be maintained with respect to the transaction. Assume further that Firm A had a robust section 6112 compliance monitoring program in place and despite this, the firm did not know that the professional did not follow firm policies and procedures with respect to this transaction. The professional who worked on the matter is no longer employed by Firm A, causing Firm A difficulty in locating the required information and in ascertaining whether the professional in question failed to comply with Firm A's list maintenance policies with respect to any other reportable transactions. Firm A is searching its records to locate information responsive to the list request and to ensure that no other reportable transactions were omitted from the list. Firm A estimates that it will take an additional 20 business days after the 20th business day to retrieve the missing information and provide IRS with the additional information responsive to the list request. Within the 20-business-day period, Firm A notifies the IRS, in writing, of the difficulties it is experiencing and requests an additional 20 business days to locate and produce the information for this one transaction and for any other reportable transactions omitted from the list as a result of the inaction by the professional in question. Within the 20-business-day period, Firm A makes all other required list information available to the IRS, together with a description of the information that is being searched for, all statements required by these regulations, and a proposed schedule to produce the missing documents.

(ii) Under these facts and circumstances, Firm A demonstrated that it could not reasonably, within the 20-business-day period, make available the portion of the list relating to one or possibly more transactions omitted from the list because of the inaction of the professional in question. Firm A therefore qualifies for an extension. Firm A had established policies and procedures reasonably designed and implemented to ensure and monitor compliance with the requirements of section 6112 and address non-compliance. Because the facts and circumstances indicate that Firm A made diligent efforts to maintain the materials constituting the list in a readily accessible form and as otherwise required under section 6112, the requested 20-business-day extension with respect to the portion of the list relating to the one known omitted transaction and to any other omitted reportable transactions resulting from the inaction of the professional in question should be granted.

(d) *Failure to make list available*. A failure to make the list available includes any failure to furnish the requested list to the IRS in a timely manner and in the form required under section 6112 and its corresponding regulations. Examples of failures to make a list available include instances in which a person fails to furnish any list; furnishes an incomplete list; or furnishes a list, whether or not complete, after the time required by this section.

(e) *Computation of penalty*—(1) *In general*. The penalty imposed by section 6708 accrues daily, beginning on the first calendar day after the expiration of the 20-business-day period following a written list request, and continues for each calendar day thereafter until the person's failure to furnish a list in the form required by section 6112 and its corresponding regulations ends. If the list is delivered or mailed to the IRS outside of the 20-business-day period, the penalty shall not apply on the day the list is delivered to the IRS or, if the list is mailed, the day the list is received by the IRS.

(2) *Computation of penalty after grant of extension.* If the IRS grants an extension of the 20-business-day period pursuant to paragraph (c)(3) of this section, the penalty imposed by section 6708 accrues daily, beginning on the first calendar day after the extension period expires, and continues for each calendar day thereafter until the person's failure to furnish a list in the form required by section 6112 and its corresponding regulations ends. If the list is delivered or mailed to the IRS outside of the period of extension, the penalty shall not apply on the day the list is delivered to the IRS or, if the list is mailed, the day the list is received by the IRS.

(3) *Designation agreements and concurrent application of penalty*. If material advisors with respect to the same reportable transaction enter into a designation agreement pursuant to section 6112(b)(2) and § 301.6112–1(f), separate penalties will be imposed on designated material advisors and nondesignated material advisors who are parties to the designation agreement for their respective periods of failure or noncompliance with a list request. A penalty will continue to accrue against a material advisor who is a party to a designation agreement until such time when a list complying with the requirements of section 6112 and its corresponding regulations is furnished by that material advisor or any other material advisor who is a party to the designation agreement.

(4) *Example*. The following example illustrates paragraph (e) of this section.

*Example*. The IRS hand delivers a written request for the list required to be maintained under section 6112 to Firm B, a material advisor, on Friday, March 10, 2017. Firm B must make the list available to the IRS on or before Friday, April 7, 2017, the 20th business day after the request was hand delivered. If Firm B fails to make the list available to the IRS by that day, absent reasonable cause or the IRS's grant of an extension of the response time, the $10,000-per-day penalty begins on Saturday, April 8, 2017. The $10,000 per day penalty will continue for each subsequent calendar day until Firm B makes the complete list available, except for those days for which Firm B demonstrates reasonable cause. If Firm B hand delivers a complete copy of the requested list to the IRS on the morning of Tuesday, April 11, 2017, absent reasonable cause or the IRS's prior grant of an extension for the response time, a penalty of $30,000 will be imposed upon Firm B (for April 8, 9, and 10). See paragraphs (g) and (h) of this section for an explanation of reasonable cause.

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

(1) *Material advisor* means a person described in section 6111 and § 301.6111–3(b).

(2) *Business day* means every calendar day other than a Saturday, Sunday, or legal holiday within the meaning of section 7503.

(3) *Reportable transaction* means a transaction described in section 6707A(c)(1) and section 1.6011–4(b)(1).

(4) *Listed transaction* means a transaction described in section 6707A(c)(2) and § 1.6011–4(b)(2) of this chapter.

(g) *Reasonable cause – general applicability*—(1) *Overview*. The section 6708 penalty will not be imposed for any day or days for which the person shows that the failure to make a complete list available to the IRS was due to reasonable cause. The determination of whether a person had reasonable cause is made on a case-by-case and day-by-day basis, taking into account all the relevant facts and circumstances. Facts and circumstances relevant to a material advisor's reasonable cause for failing to make available the list on a specific day include facts and circumstances arising after the request for the list. The person's showing of reasonable cause should relate to each specific day or days for which the person failed to make available the requested list. Factors establishing reasonable cause include, but are not limited to, factors identified in paragraphs (g) and (h) of this section.

(2) *Good-faith factors*. The most important factors to establish reasonable cause are those that reflect the extent of the person's good-faith efforts to comply with section 6112. The following factors, which are not exclusive, will be considered in determining whether a person has made a good-faith effort to comply with the section 6112 requirements:

(i) The person's efforts to determine or assess its status as a material advisor as defined by section 6111;

(ii) The person's efforts to determine the information and documentation required to be maintained under section 6112;

(iii) The person's efforts to meet its obligations to maintain a readily producible list as required by section 6112;

(iv) The person's efforts, upon receiving the list request, to make the list available to the IRS within the 20-business-day period (or extended period) under paragraphs (a), (b), and (c)(3) of this section; and

(v) The person's efforts to ensure that the list furnished to the IRS is accurate and complete.

(3) *Ordinary business care*. The exercise of ordinary business care may constitute reasonable cause. To show ordinary business care, the person may, for example, show that the person established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the section 6112 requirements. In all instances when ordinary business care is claimed as constituting reasonable cause, a person must show that the person took immediate steps, upon discovering any failure relating to the list, to correct the failure. A person's failure to take immediate steps to correct a failure related to the list upon discovering the failure is a factor weighing against a conclusion that the person exercised ordinary business care. Notwithstanding the occurrence of an isolated and inadvertent failure, a person still may be able to demonstrate that the person exercised ordinary business care, considering all the relevant facts and circumstances, but only if the person had established and adhered to procedures reasonably designed and implemented to ensure compliance with the section 6112 requirements.

(4) *Supervening events*. A person may establish reasonable cause for one or more days for which, considering all the relevant facts and circumstances, the failure to timely furnish the list required by section 6112 was due solely to a supervening event beyond the person's control. Events beyond a person's control may include fire, flood, storm, or other casualty; illness; theft; or other similarly unexpected event that damages or impairs the person's relevant business records or system for processing and providing these records, or that affects the person's ability to maintain the section 6112 list or make it available to the IRS. Reasonable cause may be established only for the period that a person who exercised ordinary business care would need to provide the list from alternative records in existence, or make the list available, under the specific facts and circumstances.

(5) *Reliance on opinion or advice*—(i) *In general*. A person may rely on an independent tax professional's advice to establish reasonable cause. The reliance, however, must be reasonable and in good faith, in light of all the other facts and circumstances. For a person to be considered to have relied on the advice, the advice must have been received by the person before the date the list is required to be made available to the IRS. If the person received advice from an independent tax professional, the person's reliance on that advice will be considered reasonable only if the independent tax professional reasonably believed that it is more likely than not that the person does not have an obligation imposed by section 6112. For example, this advice may conclude that the person is not a material advisor; that the transaction upon which the person provided material aid, assistance, or advice is not a reportable transaction for which a list was required to be maintained as of the date of the advice; that the information and documents to be produced constitute the required list; or that the information or documents withheld by the person are not required to be produced. The advice must also take into account and consider all relevant facts and circumstances, not rely on unreasonable legal or factual assumptions, not rely on or take into account the possibility that a list request may not be made, and not rely on unreasonable representations or statements of the person seeking the advice. Advice from a tax professional who is not independent may be considered in determining reasonable cause if, in light of and in relation to all the other facts and circumstances, taking into account such advice is reasonable. However, by itself, advice from a tax professional who is not independent is not sufficient to establish reasonable cause. Independent tax professional advice is not required to establish reasonable cause and the failure to obtain advice from an independent tax professional does not preclude a finding of reasonable cause if, based on the totality of all of the relevant facts and circumstances, reasonable cause has been established.

(ii) *Independent tax professional*. For purposes of this section, an independent tax professional is a person who is knowledgeable in the relevant aspects of Federal tax law and who is not a material advisor with respect to the specific transaction that is the subject of the list request. For advice related to a listed transaction, a person who is a material advisor with respect to any transaction that is the same as or substantially similar to the type of transaction that is the subject of the list request will not be considered an independent tax professional.

(6) *Examples*. The following examples illustrate this paragraph (g). These examples are intended to illustrate how the facts and circumstances in paragraphs (g)(2) through (g)(5) of this section may apply; in any given case, however, all of the facts and circumstances must be analyzed.

*Example 1*. On August 11, 2017, the IRS sends a list request via certified mail to Firm C, a material advisor. Firm C consists of a sole practitioner, X, who is away from the office on vacation on this date. X has arranged for a colleague, Y, to review Firm C's mail, email, and telephone messages daily during his absence. X returns to the office the day after his vacation ends, on September 5, 2017, and immediately contacts the IRS to notify it of his absence. Firm C makes a complete list available to the IRS on September 19, 2017, 10 business days after he has returned from vacation. Firm C establishes that X was on vacation at the time the list request was sent to Firm C, and Firm C promptly furnished the requested list in a manner and time period reflecting ordinary business care and prudence upon X's return to the office. Under these circumstances, Firm C is considered to have made a good-faith effort to comply with the section 6112 requirements. Firm C has established reasonable cause for the entire period between the expiration of the 20-business-day period following the list request and the date the list was made available to the IRS. See paragraphs (g)(2) and (3) of this section.

*Example 2*. On March 3, 2017, the IRS hand delivers to Firm D, a material advisor, a list request related to a transaction believed by the IRS to have been implemented in November 2008 by a group of Firm D's clients (the advisees). Firm D's involvement in the transaction included implementing the transaction on behalf of some but not all of the advisees. Firm D timely makes the requested list available to the IRS. Upon review, the IRS determines that the information furnished by Firm D appears to be accurate, but the IRS believes that some of the information is incomplete because it does not contain information about certain individuals who were identified through other investigative means as Firm D's clients who may have engaged in the transaction. In response to a follow-up inquiry by the IRS, Firm D establishes, however, that it is not a material advisor with respect to these taxpayers. Under these circumstances, Firm D has furnished the list as required by section 6112. Because the list was complete when furnished, Firm D need not make a showing of reasonable cause. See paragraph (g)(1) of this section.

*Example 3*. The IRS sends a list request by certified mail to Firm E, a material advisor. Firm E maintains the materials responsive to the list request on a portable data storage device. Under Firm E's established procedures for maintaining section 6112 lists, once the transaction is completed, paper documents are scanned and saved electronically according to Firm E's records management procedures. Under Firm E's records management procedures, after the scanning process is completed, Firm E sends the paper documents to an off-site storage facility. Three days before the 20th business day following the date of the written request, the electronic data is permanently destroyed. Firm E contacts the IRS representative listed as a contact person on the section 6112 list request to advise him that the relevant data was permanently destroyed. Firm E establishes that it exercised ordinary business care but that the data was nevertheless destroyed due to circumstances outside of its control. Under these circumstances, Firm E has reasonable cause for the period of time that Firm E cannot respond to the list request due to circumstances out of Firm E's control. The reasonable cause exception, however, will only be available to Firm E for the period of time that a person who exercises ordinary business care would need to obtain the materials that are part of the list, including in this case paper documents from the off-site storage facility, and furnish the list to the IRS. See paragraphs (g)(3) and (4) of section.

*Example 4*. On February 2, 2017, the IRS hand delivers a list request to Firm F, a material advisor. Firm F filed with the IRS the disclosure statement required by section 6111 for the reportable transaction that is the subject of the list request but did not maintain the section 6112 list documentation in a readily accessible format after filing the section 6111 statement. On March 3, 2017, the 20th business day (due to the Presidents' Day holiday) after the list request is delivered to Firm F, Firm F contacts the IRS to ask for additional time to comply with the list request, stating that it could not gather the list information together in 20 business days. Because Firm F is not able to show that it made diligent efforts to maintain the materials constituting the list in a readily accessible form, the IRS should not grant Firm F an extension of time. See paragraph (c)(3) of this section. Further, Firm F does not have reasonable cause because it has failed to demonstrate a good-faith effort to comply with the section 6112 requirements and ordinary business care. See paragraphs (g)(2) and (3) of this section.

*Example 5*. On August 11, 2017, the IRS sends a list request, via certified mail, to Firm G, a material advisor. Firm G consists of a sole practitioner, P. Firm G maintains the materials responsive to the list request electronically. Generally, under Firm G's records management procedures, once a transaction is completed, the documents related to that transaction are scanned and then saved electronically consistent with IRS guidance on maintaining books and records in electronic form. P is aware of the list request but ignores it. On September 24, 2017, the 13th calendar day after the 20-business-day period following the list request (due to the Labor Day holiday), P suffers a temporary but debilitating illness that lasts 22 days. Following the illness, P immediately returns to work. After returning to work, P continues to ignore the list request. In this situation, the facts and circumstances indicate that Firm G does not have reasonable cause for any day in which there was a failure to make the list available to the IRS, including the 22 days due to the intervening event, because the failure was not due solely to the supervening event occurring on September 24, 2017. Firm G did not make a good-faith effort to make the list available to the IRS before or after the supervening event occurred. Firm G is liable for the $10,000 per day penalty from the first day following the expiration of the 20-business-day period until but not including the day that Firm G furnishes the list to the IRS. See paragraphs (g)(2) and (4) of this section.

*Example 6*. On August 11, 2017, the IRS sends a list request, via certified mail, to Firm H, a material advisor. Firm H, consists of a sole practitioner, P. Firm H maintains the materials responsive to the list request electronically. Generally, under Firm H's records management procedures, once the transaction is completed, the documents are scanned and then saved electronically consistent with IRS guidance on maintaining books and records in electronic form. P is aware of the list request and begins compiling the documents to respond to the IRS within the 20-business-day period ending on September 11, 2017 (due to the Labor Day holiday). Before responding to the list request, P suffers a temporary but debilitating illness on September 3, 2017, that lasts through September 19, 2017. Upon returning to work on September 20, 2017, P contacts the IRS to explain that P experienced a temporary but debilitating illness from September 3, 2017, through September 19, 2017, and that P has returned to the office and intends to furnish the list to the IRS within a short period of time. Firm H furnishes the list to the IRS on September 22, 2017. In this situation, the facts and circumstances indicate that Firm H has reasonable cause for the period from September 12, 2017 until September 21, 2017, attributable to P's illness. The failure to furnish the list in a timely fashion was solely attributable to the supervening event occurring on September 3, 2017, and Firm H promptly furnished the requested list in a manner and time period reflecting ordinary business care upon P's return to the office. Firm H is considered to have made a good-faith effort to comply with the section 6112 requirements. Firm H has established reasonable cause for the entire period between the expiration of the 20-business-day period following the list request and the date Firm H furnished the list to the IRS. See paragraphs (g)(2) and (4) of this section.

*Example 7*. Firm I receives a list request for transactions that are the same or substantially similar to the listed transaction described in Notice 2002–21, 2002–1 CB 730. Firm I will be considered a material advisor with respect to a particular transaction for which it provided advice if the transaction is the same as or substantially similar to the transaction described in Notice 2002–21. Firm I, however, is unsure whether the transaction is the same as or substantially similar to the transaction described in this Notice. Firm I obtains an opinion from Firm L, a law firm, on this issue. P, a partner in Firm L, provided tax advice to clients who invested in other Notice 2002–21 transactions, including how to report the purported tax benefits from the transaction on their income tax returns, and Firm L is a material advisor with respect to those transactions. Because Firm L is a material advisor with respect to the type of transaction that is the same as or substantially similar to the transaction described in Notice 2002–21, Firm L is not considered an independent tax professional under paragraph (g)(5)(ii) of this section. Therefore, Firm I cannot rely on advice provided by Firm L to establish reasonable cause under this paragraph (g). The IRS may consider Firm L's advice in determining reasonable cause in light of other facts and circumstances, but Firm L's advice, without more, is not sufficient to establish reasonable cause because P is not an independent tax professional under paragraph (g)(5)(ii) of this section.

*Example 8*. Firm J, a law firm, provides advice to various clients of the firm regarding the potential tax benefits of a reportable transaction under § 1.6011–4(b)(5) of this chapter (involving a section 165 loss) and is a material advisor with respect to that transaction. Firm J also provides advice to Firm M, an accounting firm, regarding the same transaction. Firm M then advises various Firm M clients regarding this same transaction, and is a material advisor. The transaction is not a listed transaction. Firm N, a law firm that is not associated with Firm J and has not provided advice with respect to the same transaction to Firm M, has provided advice to its own clients regarding other transactions subject to § 1.6011–4(b)(5) of this chapter, but not the particular transaction that was the subject of Firm J's advice to Firm M. The IRS hand delivers a list request to Firm M, the subject of which is the transaction regarding which Firm J provided advice to Firm M. Before the expiration of the 20-business-day period, Firm M seeks advice from Firm J and Firm N about the propriety of withholding certain documents related to the transaction. Because Firm J provided advice with respect to the particular transaction that is the subject of the list request, Firm J is not an independent tax professional under paragraph (g)(5)(ii) of this section. Although Firm N has provided advice on a transaction that is considered a reportable transaction under § 1.6011–4(b)(5) of this chapter, Firm N is considered to be an independent tax professional under paragraph (g)(5)(ii) of this section because Firm N did not provide material assistance with respect to the particular transaction that is the subject of the list request.

(h) *Reasonable cause – special considerations*—(1) *Material advisor no longer in existence*. If a material advisor has dissolved, been liquidated, or otherwise is no longer in existence, the person required by section 6112 to maintain the list (the "responsible person") is subject to the penalty for failing to make the list available. In considering whether a responsible person or successor in interest has reasonable cause for any failure to timely make the list available to the IRS, the IRS will consider all of the facts and circumstances, including those facts and circumstances relating to the dissolution, liquidation, and winding up of the original material advisor's business and any efforts the original material advisor made to comply with the section 6112 requirements before the dissolution or liquidation. When appropriate or applicable, due diligence, if any, performed by a responsible person or successor in interest will be considered, and due consideration will be given for acts taken by that person to minimize the potential for violating the section 6112 requirements.

(2) *Review by IRS*. Whether reasonable cause exists for a period of time will be determined based on all the relevant facts and circumstances, including facts and circumstances arising after the request for the list. If a material advisor establishes that, in its efforts to comply with the provisions of section 6112 and its corresponding regulations, it acted in good faith, as defined in paragraph (g)(2) of this section, the material advisor will be deemed to have reasonable cause for the periods of time the IRS takes to review a furnished list for compliance with the section 6112 requirements and to inform the material advisor of any identified failures in the list. If the material advisor does not establish that it acted in good faith the IRS will not consider the time it takes to review the list or inform the material advisor of identified failures as a factor in determining whether the material advisor has reasonable cause for that period.

(3) *Examples*. The following examples illustrate paragraph (h)(2) of this section.

*Example 1*. On February 2, 2017, the IRS hand delivers a list request to Firm O, a material advisor. On March 3, 2017, the 20th business day (due to the Presidents' Day holiday) after the list request is delivered to Firm O, Firm O sends a list to the IRS that was contemporaneously prepared after Firm O issued advice with respect to the reportable transaction and continuously maintained in accordance with the requirements of section 6112 and the related regulations. Before sending the list, a supervisor at Firm O carefully reviewed the list to verify that it was comprehensive and accurate. The IRS completes its review on March 23, 2017, and determines that the list is not complete because Firm O furnished a draft copy of the tax opinion, rather than the final document, which Firm O had mistakenly misfiled. After Firm O is notified of the missing information, Firm O immediately furnishes a complete copy of the final version of the tax opinion. Firm O made a good-faith effort to comply with the section 6112 requirements, including its efforts to ensure that the list that was furnished to the IRS was accurate and complete. Firm O has reasonable cause for the entire period between the expiration of the 20-business-day period following the list request and the date it furnished the complete list to the IRS.

*Example 2*. On February 2, 2017, the IRS hand delivers a list request to Firm P, a material advisor. Firm P's involvement in the reportable transaction included implementing the transaction on behalf of some but not all of Firm P's clients. On March 3, 2017, the 20th business day (due to the Presidents' Day holiday) after the list request is delivered to Firm P, Firm P sends the list to the IRS. The IRS completes its review on March 23, 2017. The IRS believes the client list is incomplete because it does not contain information about certain individuals who were identified through other investigative means as clients of Firm P who may have engaged in the transaction. On March 27, 2017, in response to a follow-up inquiry by the IRS, Firm P establishes that it is not a material advisor with respect to these taxpayers. Therefore, the March 3, 2017 list was complete and accurate when first furnished. Under these circumstances, Firm P has timely furnished the list as required by section 6112. Because Firm P complied with the requirements of section 6112 no penalty applies, and Firm P does not need to establish reasonable cause for the period from March 4, 2017, through March 27, 2017, when the IRS was reviewing the list.

*Example 3*. On February 2, 2017, the IRS hand delivers a list request to Firm Q, a material advisor. On March 3, 2017, the 20th business day (due to the Presidents' Day holiday) after the list request is delivered to Firm Q, Firm Q sends the list to the IRS. Firm Q had not maintained a list contemporaneously after issuing the advice with respect to the reportable transaction, and created the list during the 20 business days before providing the list to the IRS. To meet the 20-business-day deadline, a supervisor did not review the final list before sending it to the IRS. The IRS completes its review on March 23, 2017, and determines that the list is not complete because it does not include 15 persons for whom Firm Q acted as a material advisor with respect to the reportable transaction. Firm Q furnishes the additional information on March 27, 2017. Because Firm Q is not able to show that it made diligent efforts to maintain the materials constituting the list in a readily accessible form and that it made a reasonable effort to ensure that the list that was furnished to the IRS was accurate and complete, Firm Q cannot establish that it exhibited a good-faith effort to comply with the section 6112 requirements. Firm Q does not have reasonable cause for its failure to furnish the complete list from March 4, 2017, through March 26, 2017.

*Example 4*. Within the 20-business-day period following a list request, Firm R sends four boxes of documents comprising the required list to the IRS using a commercial delivery service. The IRS receives only three of the boxes because box 4 was erroneously self-addressed using Firm R's office address. Box 4 arrives at Firm R's office on January 6, 2017, the 2nd calendar day after the 20th business day after the list request was made. Firm R immediately recognizes its clerical error, promptly contacts the IRS, and resends the original and unopened box 4, properly addressed, to the IRS together with documentation supporting the error. The IRS receives box 4 on January 9, 2017. Under these circumstances, Firm R has reasonable cause for the late delivery of box 4 because it made a good-faith attempt to timely comply with the list request and immediately corrected an inadvertent error upon its discovery. As a result, no penalty will be imposed based on the delay in providing box 4. If, after inspection, the IRS determines that, even with the contents of box 4, the list is incomplete or defective, Firm R must establish reasonable cause for the incomplete nature of the list or the defect to avoid imposition of a penalty for the period beginning January 5, 2017, until but not including the day that Firm R furnishes the list to the IRS.

*Example 5*. (i) Firm S is a large law firm that is a material advisor. Firm S conducts annual sessions to educate its professionals about reportable transactions and the firm's obligations related to those reportable transactions. Firm S instructs its professionals to provide information on tax engagements that involve reportable transactions and to provide the documents required to be maintained under section 6112 to Firm S's compliance officer for list maintenance purposes. Firm S's policy provides that, for each engagement involving a reportable transaction, one firm professional will send an email to the firm's compliance officer about the engagement and then direct a subordinate to send to the firm's compliance officer the documents required to be maintained.

(ii) Firm S receives a request from the IRS for a section 6112 list. In compiling its list to turn over to the IRS during the 20-business-day period, Firm S asks all professionals to ensure that they have reported all engagements involving a reportable transaction to the firm's compliance officer. Before submission to the IRS, a Firm S supervisor reviews the list to ensure completeness. Firm S has no reason to know of any deficiencies, and in compiling its list, Firm S discovers no deficiencies.

(iii) Upon review of the list, the IRS determines that the information furnished by Firm S appears to be accurate, but the IRS believes that some of the information is incomplete because it does not contain information about an individual who may have engaged in the transaction and who was identified through other investigative means as Firm S's client. In response to a follow-up inquiry by the IRS, Firm S immediately reviews its files and discovers that a former Firm S professional, who is no longer employed by Firm S, provided material advice to the individual with respect to carrying out a reportable transaction, but did not send an email to the firm's compliance officer about the transaction or direct a subordinate to send the documents required to be maintained to the firm's compliance officer. Firm S immediately furnishes the missing information and documents related to the identified omission to the IRS.

(iv) Firm S establishes that the professional in question ordinarily complied with Firm S's list maintenance procedures and that Firm S had no reason to know of this one omission or to suspect that the professional had failed to report any reportable transactions to the firm's compliance officer in accordance with the firm's policies. Firm S also immediately undertakes a thorough search of its electronic and paper files to locate any additional reportable transactions relating to the professional in question that may have been omitted from the list. Under these circumstances, Firm S has demonstrated that it has acted in good faith in its efforts to comply with section 6112 and is deemed to have reasonable cause for the period of time the IRS took to review the furnished list and to inform the material advisor of the identified failure in the list. See paragraph (h)(2) of this section. The reasonable cause exception, however, will only be available to Firm S with respect to the omission identified by the IRS for the period of time that a person who exercises ordinary business care would need to obtain the information and documents related to the identified omission. See paragraph (g)(3) of this section. With respect to any other omissions related to the same professional and not identified by the IRS, the reasonable cause exception will only be available to Firm S for the period of time that a person who exercises ordinary business care would need to ascertain whether any other reportable transactions were omitted from the list and to obtain the information and documents related to any such omissions. See paragraph (g)(3) of this section.

(i) *Effective/applicability date*. This section applies to all requests for lists required to be maintained under section 6112, including lists that persons were required to maintain under section 6112(a) as in effect before October 22, 2004, made on or after April 28, 2016.

John Dalrymple
*Deputy Commissioner for Services and Enforcement.*

Approved: March 22, 2016.

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

(Filed by the Office of the Federal Register on April 27, 2016, 8:45 a.m., and published in the issue of the Federal Register for April 28, 2016, 81 F.R. 25328)

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# T.D. 9765

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

# Suspension of Benefits under the Multiemployer Pension Reform Act of 2014

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: The Multiemployer Pension Reform Act of 2014 ("MPRA"), which was enacted by Congress as part of the Consolidated and Further Continuing Appropriations Act of 2015, relates to multiemployer defined benefit pension plans that are projected to have insufficient funds, within a specified timeframe, to pay the full plan benefits to which individuals will be entitled (referred to as plans in "critical and declining status"). Under MPRA, the sponsor of a plan in critical and declining status is permitted to reduce the pension benefits payable to plan participants and beneficiaries if certain conditions and limitations are satisfied (referred to in MPRA as a "suspension of benefits"). MPRA requires the Secretary of the Treasury (Treasury Department), in consultation with the Pension Benefit Guaranty Corporation (PBGC) and the Secretary of Labor (Labor Department), to approve or deny applications by sponsors of these plans to reduce benefits. These regulations affect active, retired, and deferred vested participants and beneficiaries of multiemployer plans that are in critical and declining status as well as employers contributing to, and sponsors and administrators of, those plans.

DATES: *Effective Date*: These regulations are effective on April 28, 2016.

*Applicability Date*: These regulations apply to suspensions for which the approval or denial is issued on or after April 26, 2016. In the case of a systemically important plan, the final regulations apply with respect to any modified suspension implemented on or after April 26, 2016.

FOR FURTHER INFORMATION CONTACT: The Department of the Treasury MPRA guidance information line at (202) 622-1559 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget under control number 1545–2260.

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 26 U.S.C. 6103.

**Background**

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 432(e)(9) of the Internal Revenue Code (Code), as amended by the Multiemployer Pension Reform Act of 2014, Division O of the Consolidated and Further Continuing Appropriations Act, 2015, Public Law No. 113–235 (128 Stat. 2130 (2014)) (MPRA).

I. *Statutory Provisions*

Section 412 of the Code contains minimum funding rules that generally apply to pension plans. Section 431 sets forth the funding rules that apply specifically to multiemployer defined benefit plans. Section 432 sets forth additional rules that apply to certain multiemployer plans in endangered or critical status and permits plans in critical status to be amended to reduce certain otherwise protected benefits (referred to as "adjustable benefits"). Section 305 of the Employee Retirement Income Security Act of 1974, Public Law 93–406 (88 Stat. 829 (1974)), as amended (ERISA), sets forth rules that are parallel to those set forth in section 432 of the Code.

Section 201 of MPRA amended section 432 to add a new status, called critical and declining status, for multiemployer defined benefit plans. Section 432(b)(6) provides that a plan is treated as being in critical and declining status if the plan satisfies any of the specified criteria for the plan to be in critical status and, in addition, is projected to become insolvent within the meaning of section 418E during the current plan year or any of the 14 succeeding plan years (or 19 succeeding plan years if the plan has a ratio of inactive participants to active participants that exceeds two to one or if the funded percentage of the plan is less than 80 percent).

Section 201 of MPRA also amended section 432(e)(9) to prescribe benefit suspension rules for plans in critical and declining status.[1] Section 432(e)(9)(A) provides that, notwithstanding section 411(d)(6) and subject to section 432(e)(9)(B) through (I), the plan sponsor of a plan in critical and declining status may, by plan amendment, suspend benefits that the sponsor deems appropriate. Section 411(d)(6) provides generally that a plan does not satisfy section 411 if an amendment to the plan decreases a participant's accrued benefit. For this purpose, a plan amendment that has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy or eliminating an optional form of benefit with respect to benefits attributable to service before the amendment is treated as reducing accrued benefits.

A suspension of benefits is defined in section 432(e)(9)(B)(i) as the temporary or permanent reduction of any current or future payment obligation of the plan to any participant or beneficiary under the plan, whether or not the participant or beneficiary is in pay status at the time of the suspension of benefits. Under section 432(e)(9)(B)(ii), any suspension will remain in effect until the earlier of when the plan sponsor provides benefit improvements in accordance with section 432(e)(9)(E) or when the suspension expires by its own terms. Thus, if a suspension does not expire by its own terms, it continues indefinitely.

Under the statute, a plan will not be liable for any benefit payments not made as a result of a suspension of benefits. All references to suspensions of benefits, increases in benefits, or resumptions of suspended benefits with respect to participants also apply with respect to benefits of beneficiaries or alternative payees of participants. See section 432(e)(9)(B)(iv).

A. *Retiree representative*

In the case of a plan with 10,000 or more participants, section 432(e)(9)(B)(v) requires the plan sponsor to select a plan participant in pay status to act as a retiree representative. The retiree representative is required to advocate for the interests of the retired and deferred vested participants and beneficiaries of the plan throughout the suspension approval process. The plan must provide for the retiree representative's reasonable expenses, including reasonable legal and actuarial support, commensurate with the plan's size and funded status.

B. *Conditions for suspensions*

Section 432(e)(9)(C) sets forth conditions that must be satisfied before a plan sponsor of a plan in critical and declining status for a plan year may suspend benefits. One condition is that the plan actuary must certify, taking into account the proposed suspension of benefits (and, if applicable, a proposed partition of the plan under section 4233 of ERISA (partition)), that the plan is projected to avoid insolvency within the meaning of section 418E, assuming the suspension of benefits continues until it expires by its own terms or, if no such expiration date is set, indefinitely.

Another condition requires the plan sponsor to determine, in a written record to be maintained throughout the period of the benefit suspension, that although all reasonable measures to avoid insolvency have been taken (and continue to be taken during the period of the benefit suspension), the plan is still projected to become insolvent unless benefits are suspended. In making the determination that all reasonable measures have been taken to avoid insolvency, the plan sponsor may choose to take into account various factors that may include one or more of ten factors identified in the statute. See section 432(e)(9)(C)(ii).

C. *Limitations on suspensions*

Section 432(e)(9)(D) contains limitations on the benefits that may be sus-

[1]Section 201 of MPRA makes parallel amendments to section 305 of ERISA. The Department of the Treasury has interpretive jurisdiction over the subject matter of these provisions under ERISA as well as the Code. See also section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713). Thus, these regulations issued under section 432 of the Code apply as well for purposes of section 305 of ERISA.

pended, some of which apply to plan participants and beneficiaries on an individual basis and some of which apply on an aggregate basis. Under the statute, an individual's monthly benefit may not be reduced below 110 percent of the monthly benefit that is guaranteed by PBGC under section 4022A of ERISA on the date of the suspension. In addition, no benefits based on disability (as defined under the plan) may be suspended. In the case of a participant or beneficiary who has attained age 75 as of the effective date of a suspension, the statute provides that the suspension may not exceed the applicable percentage of the individual's maximum suspendable benefit (the age-based limitation). The maximum suspendable benefit is the maximum amount of an individual's benefit that would be suspended without regard to the age-based limitation. The applicable percentage is a percentage that is calculated by dividing (i) the number of months during the period that begins with the month after the month in which the suspension is effective and ends with the month in which that participant or beneficiary attains the age of 80 by (ii) 60 months. Thus, the suspension cannot apply to the benefit of an individual who has attained age 80 as of the end of the month that includes the effective date of the suspension.

Section 432(e)(9)(D) also requires the aggregate benefit suspensions (considered, if applicable, in connection with a partition) to be reasonably estimated to achieve, but not materially exceed, the level that is needed to avoid insolvency. If a suspension of benefits is made in combination with a partition, the statute provides that the suspension may not occur before the effective date of the partition. Under the statute, any suspension of benefits must be equitably distributed across the participant and beneficiary population, taking into account various factors chosen by the plan sponsor that may include one or more of 11 factors identified in the statute. Section 432(e)(9)(D)(vii) provides additional rules that apply to certain plans.

### D. *Benefit improvements*

Section 432(e)(9)(E) sets forth rules relating to benefit improvements made while a suspension of benefits is in effect. Under this provision, a benefit improvement is defined as a resumption of suspended benefits, an increase in benefits, an increase in the rate at which benefits accrue, or an increase in the rate at which benefits become nonforfeitable under the plan.

The statute provides that a plan sponsor may, in its sole discretion, provide benefit improvements while a suspension of benefits is in effect. However, a plan sponsor may not increase plan liabilities by reason of any benefit improvement for any participant or beneficiary who is not in pay status (in other words, those who are not yet receiving benefits, such as active employees or deferred vested employees) unless (1) the benefit improvement is accompanied by an equitable distribution of benefit improvements for those who have begun to receive benefits (typically, retirees), and (2) the plan actuary certifies that, after taking the benefit improvement into account, the plan is projected to avoid insolvency indefinitely. Whether an individual is in pay status for this purpose is generally based on whether the individual's benefits began before the first day of the plan year for which the benefit improvement would take effect.

### E. *Notice of proposed suspension*

A plan sponsor may not suspend benefits unless notice is provided in accordance with section 432(e)(9)(F). Under this section, concurrently with an application to suspend benefits under section 432(e)(9)(G), the plan sponsor must give notice to: (1) Plan participants and beneficiaries who may be contacted by reasonable efforts, (2) each employer that has an obligation to contribute (within the meaning of section 4212(a) of ERISA) under the plan, and (3) each employee organization that represents plan participants employed by those employers for purposes of collective bargaining. The notice must contain sufficient information to enable individuals to understand the effect of any suspension of benefits, including an individualized estimate (on an annual or monthly basis) of the effect on each participant or beneficiary. The notice must also contain certain other specified information. The notice must be provided in a form and manner prescribed in guidance issued by the Treasury Department in consultation with PBGC and the Labor Department, written in a manner so as to be understood by the average plan participant, and may be provided in written, electronic, or other appropriate form to the extent it is reasonably accessible to those to whom notice must be furnished.

Any notice provided under section 432(e)(9)(F)(i) will satisfy the requirement for notice of a significant reduction in benefits described in section 4980F. See section 432(e)(9)(F)(iv).

### F. *Approval or rejection of proposed suspension*

Section 432(e)(9)(G) describes the process for approval or rejection of a plan sponsor's application for a suspension of benefits. Under the statute, the Treasury Department, in consultation with PBGC and the Labor Department, must approve an application upon finding that the plan is eligible for the suspension and has satisfied the criteria of sections 432(e)(9)(C), (D), (E), and (F). In evaluating whether a plan sponsor has met the criteria in section 432(e)(9)(C)(ii) (a plan sponsor's determination that, although all reasonable measures have been taken, the plan will become insolvent if benefits are not suspended), the plan sponsor's consideration of factors listed in that clause must be reviewed. The statute also requires that the plan sponsor's determinations in an application for a suspension of benefits be accepted unless they are clearly erroneous.

Section 432(e)(9)(G) also requires an application for a suspension of benefits to be published on the website of the Department of the Treasury and requires the Treasury Department to publish a notice in the **Federal Register** within 30 days of receiving a suspension application. The notice must solicit comments from contributing employers, employee organizations, and participants and beneficiaries of the plan for which a suspension application was made, as well as other interested parties.

Within 225 days after an application for a suspension of benefits is submitted, the statute requires the Treasury Department, in consultation with PBGC and the Labor Department, to approve or deny the application. If the plan sponsor is not notified within that 225-day period that it has failed to satisfy one or more applicable requirements, then the application is deemed to be approved. If the application is rejected, then a notice to the plan sponsor must detail the specific reasons for the rejection, including reference to the specific requirement not satisfied. Approval or denial of an application is treated as final agency action for purposes of 5 U.S.C. 704 (that is, the approval or denial is treated as final agency action for purposes of the Administrative Procedure Act, Public Law 79–404 (60 Stat. 237 (1946), as amended (APA)).

G. *Participant vote on proposed benefit reduction*

If a suspension application is approved, it cannot take effect before a vote of plan participants and beneficiaries on the suspension is conducted. *See* section 432(e)(9)(H). The vote will be administered by the Treasury Department, in consultation with PBGC and the Labor Department, within 30 days after approval of the suspension application. The plan sponsor is required to provide a ballot for the vote (subject to approval by the Treasury Department, in consultation with PBGC and the Labor Department). The ballot must include certain information specified in the statute. If a majority of plan participants and beneficiaries do not vote to reject the suspension, then the statute requires the Treasury Department, in consultation with PBGC and the Labor Department, to issue a final authorization to suspend benefits within seven days after the vote.

If a majority of plan participants and beneficiaries vote to reject the suspension, then the statute requires the Treasury Department, in consultation with PBGC and the Labor Department, to determine whether the plan is a systemically important plan no later than 14 days after the results of the vote are certified. A systemically important plan is a plan for which PBGC projects the present value of projected financial assistance payments to exceed $1.0 billion, as indexed, if suspensions are not implemented.

If a majority of plan participants and beneficiaries vote to reject the suspension and the plan is not a systemically important plan, a final authorization to suspend benefits will not be issued. In such a case, the statute provides that the plan sponsor may submit a new application for approval of a suspension of benefits to the Treasury Department.

If it is determined that the plan is systemically important, then the Participant and Plan Sponsor Advocate selected under section 4004 of ERISA[2] has a 30-day period to submit recommendations to the Treasury Department with respect to the suspension that was rejected by the vote or recommendations for any modifications to that suspension. Even if that suspension was rejected by the vote, the statute requires the Treasury Department to permit the implementation of either: (1) The proposed benefit suspension, or (2) a modification of that suspension made by the Treasury Department in consultation with PBGC and the Labor Department. The Treasury Department must complete this requirement within 90 days after certification of the results of a vote rejecting a suspension for a systemically important plan (and a modification of the suspension by the Treasury Department is permitted only if the plan is projected to avoid insolvency under the modification). In such a case, the statute requires the Treasury Department to issue the final authorization to suspend in sufficient time to allow the suspension or a modified suspension to be implemented by the end of the 90-day period following certification of the results of that vote.

Section 432(e)(9)(I)(i) allows a plan sponsor to challenge a denial of an application for suspension only after the application is denied. Under the statute, an action challenging the approval of a suspension may be brought only following the issuance of a final authorization to suspend. The statute also provides that a court will review an action challenging approval of a suspension of benefits in accordance with 5 U.S.C. 706 (which sets forth the standard of review applicable for purposes of the APA) and will not grant a temporary injunction with respect to a suspension unless it finds a clear and convincing likelihood that the plaintiff will prevail on the merits. Under section 432(e)(9)(I)(iii), participants and beneficiaries affected by a suspension "shall not have a cause of action under this title." An action challenging either the approval of a suspension of benefits or the denial of an application for a suspension of benefits may not be brought more than one year after the earliest date on which the plaintiff acquired or should have acquired actual knowledge of the existence of the cause of action. See section 432(e)(9)(I)(iv).

II. *Regulatory and Other Administrative Guidance*

On February 18, 2015, the Department of the Treasury issued a Request for Information on Suspensions of Benefits under the Multiemployer Pension Reform Act of 2014 in the **Federal Register** (80 FR 8578) (request for information). The request for information included questions focusing on certain matters to be addressed in guidance implementing section 432(e)(9) and indicated that multiemployer plans should not submit applications for suspensions of benefits prior to a date specified in such future guidance.

On June 19, 2015, the Treasury Department and the IRS published temporary (TD 9723) and proposed regulations (REG–102648–15) under section 432(e)(9) in the **Federal Register** at 80 FR 35207 and 80 FR 35262, respectively (June 2015 regulations). The June 2015 regulations provide guidance regarding section 432(e)(9), setting forth the requirements for a plan sponsor to apply for a suspension of benefits and for the Treasury Department to process such an application. The June 2015 regulations reflect consideration of comments received in response to the request for information. The preamble to the June 2015 temporary regulations states that it is expected that no application proposing a benefit suspension will be approved prior to the issuance of final regulations, and that, if a plan sponsor chooses to submit an application for

[2] Pursuant to section 4004 of ERISA, the Participant and Plan Sponsor Advocate acts as a liaison between PBGC, sponsors of defined benefit pension plans insured by PBGC, and participants in plans trusteed by PBGC, and performs related duties.

approval of a proposed benefit suspension before the issuance of final regulations, then the plan sponsor may need to revise the proposed suspension (and potentially the related notices to plan participants) or supplement the application to take into account any differences in the final regulations.

On June 19, 2015, the IRS also released Rev. Proc. 2015–34, 2015–27 I.R.B. 4. The revenue procedure details application procedures for a proposed suspension of benefits and also contains a model notice under section 432(e)(9)(F).

On September 2, 2015, the Treasury Department and the IRS published temporary (TD 9735) and proposed regulations (REG–123640–15) on the voting provisions under section 432(e)(9)(H) in the **Federal Register** at 80 FR 52972 and 80 FR 53068, respectively (September 2015 regulations). The September 2015 regulations reflect consideration of comments received pursuant to the request for information.

On September 10, 2015, the Treasury Department and the IRS conducted a public hearing on the June 2015 regulations, at which speakers also commented on the September 2015 regulations. A public hearing on the September 2015 regulations was held on December 18, 2015.

On February 11, 2016, the Treasury Department and the IRS published proposed regulations (REG–101701–16) regarding the specific limitation on a suspension of benefits under section 432(e)(9)(D)(vii) in the **Federal Register** at 81 FR 7253 (February 2016 regulations). This specific limitation governs the application of a suspension of benefits under any plan that includes benefits directly attributable to a participant's service with any employer that has, prior to December 16, 2014, withdrawn from the plan in a complete withdrawal, paid its full withdrawal liability, and, pursuant to a collective bargaining agreement, assumed liability for providing benefits to participants and beneficiaries equal to any benefits for such participants and beneficiaries reduced as a result of the financial status of the plan. A public hearing on the February 2016 regulations was held on March 22, 2016.

After consideration of the comments received, the provisions of the June 2015 proposed regulations and the September 2015 proposed regulations (collectively, "2015 regulations") are adopted by this Treasury decision, subject to certain changes that are summarized in this preamble. This Treasury decision also removes the temporary regulations under 432(e)(9) that were published in June 2015 and September 2015. This Treasury decision does not contain final action on the February 2016 regulations. On April 26, 2016 the IRS released Rev. Proc. 2016–27, 2016–19 I.R.B.__, which updates the application procedures and model notice set forth in Rev. Proc. 2015–34. The Treasury Department consulted with PBGC and the Labor Department in developing these regulations and other guidance.

## Explanation of Provisions

### I. *Overview*

These final regulations provide guidance on requirements under section 432(e)(9) regarding a suspension of benefits under a multiemployer defined benefit plan that is in critical and declining status. Except as otherwise provided, these final regulations adopt the provisions of the 2015 regulations.

### II. *General Rules On Suspension of Benefits*

These final regulations provide that, subject to section 432(e)(9)(B) through (I), the plan sponsor of a multiemployer plan that is in critical and declining status within the meaning of section 432(b)(6) for a plan year may, by plan amendment, implement a suspension of benefits that the plan sponsor deems appropriate. Such a suspension is permitted notwithstanding the generally applicable anti-cutback provisions of section 411(d)(6). The final regulations clarify that, as amended, the terms of the plan must satisfy the requirements of section 401(a). For example, after the effective date of a plan amendment imposing a suspension of benefits, the plan must satisfy the requirements of section 411 with respect to the accrued benefit as reduced, if applicable, pursuant to that amendment. The plan amendment implementing a suspension of benefits must be adopted in a plan year in which the plan is in critical and declining status.

#### A. *Contingent suspensions*

The 2015 regulations provide that once a plan is amended to suspend benefits, the plan may pay or continue to pay a reduced level of benefits pursuant to the suspension only if the terms of the plan are consistent with the requirements of section 432(e)(9) and the regulations. The 2015 regulations state that a plan's terms are consistent with the requirements of section 432(e)(9) even if they provide that, instead of a suspension of benefits occurring in full on a specified effective date, the amount of a suspension will phase in or otherwise change in a definite, pre-determined manner as of a specified future effective date or dates. The 2015 regulations indicate that a plan's terms are inconsistent with the statutory requirements, however, if they provide that the amount of a suspension will change contingent upon the occurrence of any other specified future event, condition, or development. For example, a plan is not permitted to provide that an additional or larger suspension of benefits is triggered if the plan's funded status deteriorates. Similarly, the 2015 regulations provide that a plan is not permitted to provide that, contingent upon a specified future event, condition, or development, a suspension of benefits will be automatically reduced (except if the plan sponsor fails to make the annual determination that the plan would not be projected to avoid insolvency unless benefits are suspended).

Some commenters objected to the provisions of the 2015 regulations that treat contingencies as inconsistent with the requirements of section 432(e)(9) and asked that certain types of contingencies, such as contingencies based on actuarial gain or loss, be allowed. These commenters assert that permitting these types of contingent suspensions would be consistent with the policy underlying the rule that the aggregate suspension be reasonably estimated to achieve, but not materially exceed, the level necessary to avoid plan insolvency.

Permitting benefits to be reduced or increased on the occurrence of future contingencies, however, would raise a number of difficult challenges in complying with statutory requirements: The additional complexity of the calculations relating to whether the solvency requirements are satisfied and whether the distribution of the suspension is equitable; the inability of the suspension notice to sufficiently inform affected individuals of the actual reduction to their benefits; and the potential that the contingent suspension could effectively result in benefit increases that fail to comply with the statutory requirements relating to benefit increases. Therefore, the final regulations retain the general rule that contingent suspensions are inconsistent with the requirements of section 432(e)(9).

However, individual-level contingencies do not raise the same concerns as other post-suspension contingencies. Accordingly, the final regulations clarify that a suspension can take into account individual-level contingencies (such as retirement, death, or disability) for individuals who have not commenced benefits before the effective date of the suspension. For example, a suspension of benefits can reduce early retirement subsidies with respect to participants who have not commenced benefits before the effective date of the suspension. Without this clarification, this type of reduction could be viewed as impermissible (because the level of the suspension would be based on whether and when an individual chooses to retire early).

Although the final regulations permit certain individual-level contingencies, the post-suspension terms of the plan must satisfy all of the qualification requirements of section 401(a). Thus, for example, an individual-level, post-suspension contingency that reduces an early retirement subsidy would be permitted, provided that the suspension does not result in an early retirement benefit that is less valuable than the post-suspension accrued benefit.

B. *Definitions*

As under the 2015 regulations, these final regulations apply the section 432(j)(6) definition of a person in pay status under a multiemployer plan. Under that definition, a person is in pay status if, at any time during the current plan year, the person is a participant, beneficiary, or alternate payee under the plan and is paid an early, late, normal, or disability retirement benefit under the plan (or a death benefit under the plan related to a retirement benefit).

These final regulations define the term plan sponsor to mean the association, committee, joint board of trustees, or other similar group of representatives of the parties that establishes or maintains the multiemployer plan. However, in the case of a plan described in section 404(c), or a continuation of such a plan, the term plan sponsor means the association of employers that is the employer settlor of the plan.

In the case of an individual who is receiving benefits when the suspension is implemented, the final regulations provide that the effective date of suspension is the first date as of which any of the individual's benefits are not paid as a result of the suspension.

In the case of an individual who is not receiving benefits as of the date a suspension is implemented, the 2015 regulations define the effective date of suspension as the first date as of which the individual's accrued benefit is reduced as a result of the suspension. In connection with the new provision in the final regulations permitting suspensions with individual-level contingencies, the final regulations provide a revised definition of effective date of suspension that applies with respect to an individual who is not receiving benefits as of the date the suspension is implemented and for whom the suspension reduces benefits that are not accrued benefits. For such an individual, the effective date of suspension is the first date as of which the individual's entitlement to benefits is reduced as a result of the implementation of the suspension, regardless of whether the individual is eligible to commence benefits at that date. This change to the definition of effective date of suspension will affect situations in which early retirement factors are changed in a manner that reduces the early retirement benefit (independent of any reduction of the accrued benefit) and the final regulations include an example of a suspension that provides for the reduction of an early retirement benefit effective January 1, 2019. In that case, the effective date of the suspension is January 1, 2019, even for a participant who does not commence benefits until a later year.

As under the June 2015 regulations, the final regulations provide that, if a suspension of benefits includes more than one reduction in benefits over time, such that benefits are scheduled to be reduced by an additional amount after benefits are first reduced pursuant to the suspension, then each date as of which benefits are reduced is treated as a separate effective date of the suspension. This requires, for example, that the age-based limitation be separately applied as of the effective date of each reduction under such a phased-in suspension. However, if the effective date of the final scheduled reduction in benefits in a series of reductions pursuant to a phased-in suspension is less than three years after the effective date of the first reduction then, in the interest of avoiding undue administrative complexity, the effective date of the first reduction will be treated as the effective date of all subsequent reductions pursuant to that suspension. For example, if a suspension provides that benefits will be reduced by a specified percentage effective January 1, 2017, by an additional percentage effective January 1, 2018, and by an additional percentage effective January 1, 2019, with no subsequent changes scheduled, it would meet the three-year condition to treat January 1, 2017, as the effective date for all three reductions. However, if the suspension provided for a further reduction effective January 1, 2020, the suspension would not be treated as satisfying the three-year condition and therefore would be treated under the regulations as having four separate effective dates.

The final regulations define the term suspension of benefits to mean the temporary or permanent reduction, pursuant to the terms of the plan, of any current or future payment obligation of the plan with respect to any plan participant. A suspension of benefits can apply with respect to a plan participant regardless of whether the participant, beneficiary, or alternate payee has commenced receiving benefits before the effective date of the suspension of benefits. If a plan pays a reduced level of benefits pursuant to a suspension of benefits that complies with the requirements of section 432(e)(9), then the plan is not liable for any benefits not paid as a result of the suspension.

A suspension of benefits may be of indefinite duration or may expire as of a certain date, and any expiration date for a suspension of benefits must be specified in the plan amendment implementing the suspension. The final regulations provide that a plan sponsor may amend the plan to eliminate some or all of a suspension of benefits, provided that the amendment satisfies the requirements that apply to benefit improvements under section 432(e)(9)(E) (see section VI of this preamble). The final regulations also provide that, except as otherwise specified, all references to suspensions of benefits, increases in benefits, or resumptions of suspended benefits with respect to participants also apply with respect to benefits of beneficiaries or alternate payees (as defined in section 414(p)(8)) of participants.

III. *Retiree Representative*

The final regulations generally adopt, with some clarifications, the provisions of the 2015 regulations with respect to the retiree representative. The retiree representative, who must be a plan participant in pay status, is selected by the plan sponsor to advocate for the interests of the retired and deferred vested participants and beneficiaries of the plan throughout the suspension approval process.

The final regulations implement the requirement that a retiree representative must be selected for a plan with 10,000 or more participants. For purposes of determining whether a plan has 10,000 or more participants, the final regulations provide that the number of participants is the number reported on the most recently filed Form 5500, "Annual Return/Report of Employee Benefit Plan."[3] The final regulations also provide that the plan sponsor must select the retiree representative at least 60 days before the plan sponsor submits an application to suspend benefits and that the retiree representative must be a plan participant who is in pay status and may or may not be a plan trustee.

In order to increase retiree representation in connection with applications to suspend benefits, the final regulations permit a plan sponsor of a plan that has fewer than 10,000 participants to select a retiree representative in connection with such an application and plan sponsors are encouraged to do so. If a retiree representative is selected for such a plan, the rules that apply to retiree representatives for plans with 10,000 or more participants (other than the rule concerning the size of the plan and the timing of the appointment) will apply.

The final regulations require that, upon request, the plan sponsor must promptly provide the retiree representative with relevant information (such as plan documents and data) that is reasonably necessary to enable the retiree representative to perform the retiree representative's role, which includes, for example, the retiree representative's attendance at trustee meetings at which the suspension design is being developed. This requirement applies both while the suspension is being developed and during the period while the suspension application is pending with the Treasury Department. The final regulations provide for the retiree representative to serve in this role beginning before the plan sponsor submits this application and to continue in this role, at the discretion of the plan sponsor, throughout the entire period of the benefit suspension, rather than only until the completion of the suspension approval process. Such an extension would enable the retiree representative to monitor compliance with the ongoing requirements relating to the suspension, such as the requirement that the plan sponsor make annual determinations that all reasonable measures to avoid insolvency have been taken and continue to be taken but that a suspension is necessary to avoid insolvency, and that the plan sponsor follow the rules relating to benefit improvements.

The final regulations adopt the provision from the 2015 regulations that requires the plan to pay reasonable expenses incurred by the retiree representative, commensurate with the plan's size and funded status, with slight modifications. The expenses that must be paid by the plan include reasonable expenses for legal and actuarial support, which may be obtained to influence the design of a suspension, to analyze a proposed suspension contained in an application, or for other advocacy purposes. Numerous commenters noted the importance of communication between the retiree representative and retired and deferred vested participants and beneficiaries. In response, the final regulations clarify that the plan must pay other reasonable expenses incurred by the retiree representative, such as any reasonable expenses incurred in communicating with the retired and deferred vested participants and beneficiaries of the plan about the proposed suspension (because communication with these individuals is generally necessary to advocate for their interests). The final regulations include, as an example of a type of expense that the plan must pay, any reasonable expense incurred in communicating with retired and deferred vested participants and beneficiaries of the plan. This clarification was made to reflect that communicating with these individuals is a necessary component of advocating for their interests.

The types of communication that are necessary to enable the retiree representative to advocate for the interests of retired and deferred vested participants and beneficiaries typically include soliciting input directly from these individuals that could be used to influence the design of a suspension before the plan sponsor applies for approval of a suspension. After an application for suspension has been submitted for approval, necessary communication would generally include providing these individuals with additional information regarding the proposed suspension and the suspension approval process so that they can submit comments. Communication also includes meeting with groups of affected individuals (either in person or telephonically), so that the retiree representative can better understand their concerns and the potential effects of a proposed suspension in order to advocate on behalf of the retired and deferred vested participants and beneficiaries when preparing a comment or in recommending that the plan sponsor withdraw the application and submit a revised suspension. To further this communication, the plan sponsor should inform the retiree representative of, and invite the retiree repre-

[3]On the Form 5500 for the 2015 plan year, this is the total number of participants as of the end of the plan year that is reported on Part II, Line 6f.

sentative to, any meetings between the plan sponsor and the retirees, deferred vested participants and beneficiaries regarding the proposed suspension.

If a retiree representative is unwilling or unable to fulfill his or her obligations, then the retiree representative can be replaced so that the retirees, deferred vested participants and beneficiaries have representation throughout the process.

The final regulations refer to section 432(e)(9)(B)(v)(III) for rules relating to the fiduciary status of a retiree representative, but do not provide additional guidance with respect to this provision.

IV. *Conditions for Suspensions*

A plan sponsor of a plan in critical and declining status may suspend benefits only if the actuarial certification requirement in section 432(e)(9)(C)(i) and the plan sponsor determinations requirements in section 432(e)(9)(C)(ii) are satisfied. Under the final regulations, a plan sponsor may not suspend benefits unless the plan sponsor makes initial and annual determinations that the plan is projected to become insolvent unless benefits are suspended, although all reasonable measures to avoid insolvency have been taken. These determinations are based on the non-exclusive list of factors described in section 432(e)(9)(C)(ii).

A. *Actuarial certification*

As under the 2015 regulations, the final regulations provide that the actuarial certification requirement in section 432(e)(9)(C)(i) is satisfied if, taking into account the proposed suspension of benefits (and, if applicable, a proposed partition of the plan), the plan's actuary certifies that the plan is projected to avoid insolvency within the meaning of section 418E,[4] assuming the suspension of benefits continues until it expires by its own terms or, if no such expiration date is set, indefinitely. The final regulations prescribe rules for the comparable requirement that the suspension (in combination with a partition, if applicable) be reasonably estimated to avoid insolvency under section 432(e)(9)(D)(iv).

B. *Plan sponsor determinations*

1. Initial Plan Sponsor Determinations

The final regulations adopt, with modifications described herein, the provisions of the 2015 regulations that a plan satisfies the initial plan sponsor determinations requirement only if the plan sponsor determines that: (1) All reasonable measures to avoid insolvency, within the meaning of section 418E, have been taken, and (2) the plan would not be projected to avoid insolvency if no suspension of benefits were applied under the plan.

The final regulations provide that a plan sponsor, in making its determination that all reasonable measures to avoid insolvency have been taken, may take into account the non-exclusive list of factors set forth in section 432(e)(9)(C)(ii). In addition, when making the initial determination that the plan would not be projected to avoid insolvency if no suspension of benefits were applied under the plan, the final regulations provide that a plan sponsor may rely on the actuarial certification made pursuant to section 432(b)(3)(A)(i) that the plan is in critical and declining status for the plan year.

2. Annual plan sponsor determinations

Under the 2015 regulations, a plan sponsor would satisfy the annual plan sponsor determinations requirement for a plan year only if the plan sponsor determines, no later than the last day of that plan year, that: (1) All reasonable measures to avoid insolvency have been and continue to be taken, and (2) the plan is projected to become insolvent unless the suspension of benefits continues (or another suspension of benefits under section 432(e)(9) is implemented) for the plan. One commenter suggested that the language in the 2015 regulations was not clear as to what should occur in the event a plan's finances worsen significantly after a suspension is implemented, so that even if the maximum permissible suspension were implemented the plan would not be able to avoid insolvency. The commenter presented one potential interpretation, in which the worsened financial situation would prohibit the plan sponsor from making the required annual determination, and, as a result, the suspension could not remain in effect. The commenter observed that it would be illogical to interpret this requirement to mean that a plan sponsor could not meet the required certification in such a case, resulting in an end to the suspension. This was not the intent of the 2015 regulations. Accordingly, the final regulations clarify that the standard for this determination (as well as the initial plan sponsor determination) is whether, absent a suspension of benefits, the plan would not be projected to avoid insolvency.

As under the 2015 regulations, the final regulations require that the projection of the plan's avoidance of insolvency must be made using the standards that apply for purposes of determining whether a suspension is sufficient to avoid insolvency, as described in section V.B.1 of this preamble. The final regulations provide that the plan sponsor must maintain a written record of its annual determinations in order to satisfy the annual plan sponsor determinations requirement. This written record must be included in an update to the rehabilitation plan (described in § 432(e)(3)), whether or not there is otherwise an update for that year or, if the plan is no longer in critical status, in the documents under which the plan is maintained (so that it is available to plan participants and beneficiaries). The plan sponsor's consideration of factors required for its determination of whether all reasonable measures have been taken must be reflected in that written record.

The final regulations provide that if a plan sponsor fails to satisfy the annual plan sponsor determinations requirement for a plan year (including maintaining the written record), then the suspension of benefits expires as of the first day of the next plan year. For example, if, in a plan year, the plan sponsor is unable to determine that all reasonable measures to avoid insolvency have been taken, then the plan sponsor must take those additional reasonable measures before the end of the plan year (and reflect those measures in the written record accordingly) in order to

[4]Under section 418E(b)(1), in general, a multiemployer plan is insolvent for a plan year if the plan's available resources are not sufficient to pay plan benefits when due for the plan year.

avoid the expiration of the suspension as of the first day of the next plan year.

If there is favorable actuarial experience, so that the plan could avoid insolvency even if the benefit suspension were reduced (but not eliminated), the plan sponsor may wish to adopt a benefit increase that partially restores suspended benefits in order to share that favorable experience with the participants. Section 432(e)(9)(E) sets forth the requirements for such a partial restoration of suspended benefits and for other benefit improvements. If favorable actuarial experience would allow the plan to avoid insolvency if the benefit suspension were eliminated entirely, the plan sponsor would be unable to make the determination that a suspension is necessary to avoid insolvency. In such a case, the plan sponsor's inability to make the annual plan sponsor determination would require the plan sponsor to eliminate the suspension as of the first day of the next plan year.

V. *Limitations on Suspensions*

The final regulations generally adopt the individual and aggregate limitations on a suspension of benefits under section 432(e)(9)(D) as provided under the 2015 regulations, with minor clarifications. The regulations provide that after applying the individual limitations, the overall size and distribution of the suspension is subject to the aggregate limitations.

A. *Individual limitations on suspensions*

1. Guarantee-based Limitation

The final regulations provide that the monthly benefit payable to a participant, beneficiary, or alternate payee may not be less than 110 percent of the monthly benefit that would be guaranteed by PBGC under section 4022A of ERISA if the plan were to become insolvent as of the effective date of the suspension (the guarantee-based limitation). Under section 4022A(c)(1) of ERISA, that guaranteed amount is a dollar amount multiplied by the participant's years and months of credited service as of the relevant date (in this case, the effective date of the suspension). The dollar amount is 100 percent of the accrual rate up to $11 per month, plus 75 percent of the lesser of (1) $33, or (2) the accrual rate, if any, in excess of $11. The accrual rate is a participant's or beneficiary's monthly benefit (described in section 4022A(c)(2)(A) of ERISA) divided by the participant's years of credited service (described in section 4022A(c)(3) of ERISA) as of the effective date of the suspension. The final regulations include examples demonstrating how the PBGC guarantee is calculated, which reflect PBGC's interpretation of section 4022A of ERISA.

In determining the participant's monthly benefit for purposes of the accrual rate, only nonforfeitable benefits (other than benefits that become nonforfeitable on account of plan termination) are taken into account, pursuant to section 4022A(a) of ERISA. The final regulations treat benefits that are forfeitable on the effective date of a suspension as nonforfeitable, provided the participant is in covered employment on that date and would have a nonforfeitable right to those benefits upon completion of vesting service following that date. For example, if an active participant had only three out of five years of service necessary for the participant's benefit to become 100 percent vested under a plan as of the effective date of a suspension, the participant's accrued benefit will be treated as 100 percent vested as of that date.

2. Disability-based Limitation

The final regulations incorporate the statutory requirement that benefits based on disability as defined under the plan may not be suspended. Like the 2015 regulations, the final regulations provide that the term "benefits based on disability" means the entire amount paid by the plan to a participant pursuant to the participant becoming disabled, regardless of whether a portion of that amount would have been paid if the participant had not become disabled. For example, assume that a participant with an accrued benefit of $1,000 per month, payable at age 65, becomes entitled under the plan to a benefit in that amount beginning at age 55 on account of a disability (as defined in the plan) and elects to commence that benefit. Under the plan, absent disability, the participant would have been entitled only to a reduced early retirement benefit of $600 per month commencing at age 55, but the reduction for early retirement does not apply because the participant has elected to commence a benefit on account of a disability. The participant's entire benefit payment of $1,000 per month commencing at age 55 is a benefit based on disability, even though the participant would have received a portion of these benefits at retirement regardless of the disability.

The final regulations provide that if a participant begins receiving an auxiliary or other temporary disability benefit and the sole reason the participant ceases receiving that benefit is commencement of retirement benefits, the benefit based on disability after commencement of retirement benefits is the lesser of: (1) The periodic payment the participant was receiving immediately before the participant's retirement benefits commenced, or (2) the periodic payment to the participant of retirement benefits under the plan.

For example, assume that a participant begins receiving a disability benefit under the plan of $1,000 per month payable at age 55. When the participant attains age 65, the participant's disability benefit is discontinued and the participant elects to commence payment of the participant's accrued benefit in the form of an actuarially equivalent joint and survivor annuity payable in the amount of $850 per month. Alternatively, if the participant had elected to commence payment of the participant's accrued benefit in the form of a single life annuity, the amount payable would be $1,000 per month. The benefit based on disability is $1,000 per month before age 65 and, depending on the participant's election, either $850 per month or $1,000 per month beginning at age 65. A suspension of benefits is not permitted to apply to any portion of those benefits at any time.

A number of commenters suggested that benefits based on disability should also include retirement benefits elected by participants who, despite qualifying for benefits based on disability under the plan, elected retirement benefits that were greater than the disability benefits available under the plan. The final regulations do not adopt this suggestion because the disability-based limitation applies only to benefits based on disability (as defined under the plan). Accordingly, because these individuals did not elect disability benefits under the plan, they are not considered to have benefits based on disability for purposes of the disability-based limitation. Similarly, the beneficiary of an individual who had benefits based on disability is not considered to be receiving benefits based on disability under the plan for purposes of the disability-based limitation. Nonetheless, a plan sponsor is permitted to use a broader definition of disability (or to protect beneficiaries of disabled individuals) when designing a suspension of benefits, provided that the suspension otherwise meets the applicable requirements. The regulations include examples of such suspension designs, including a new example that is discussed in section V.B.4 of this preamble.

3. Age-based Limitation

The final regulations generally adopt the provisions of the 2015 regulations with respect to the age-based limitations with minor clarifications. The final regulations provide that no suspension of benefits is permitted to apply to a participant or beneficiary who has commenced receiving benefits as of the effective date of the suspension and has attained age 80 no later than the end of the month that includes the effective date of the suspension. For example, if a suspension of benefits has an effective date of December 1, 2017, then the suspension cannot apply to the monthly benefit of a retiree who is 79 on December 1, 2017 and who attains age 80 on December 15, 2017. In addition, the final regulations provide that no more than the applicable percentage of the maximum suspendable benefit may be suspended for a participant or beneficiary who has commenced receiving benefits as of the effective date of the suspension and has reached age 75 by the end of the month that includes the effective date of the suspension.

The final regulations provide that the maximum suspendable benefit is the portion of an individual's benefits that would be suspended without regard to the age-based limitation, after the application of the guarantee-based limitation and the disability-based limitation, described earlier in this preamble.

The applicable percentage is the percentage obtained by dividing: (1) The number of months during the period beginning with the month after the month in which the suspension of benefits is effective and ending with the month during which the participant or beneficiary attains the age of 80, by (2) 60.

The final regulations explain how to apply the age-based limitation if benefits have not commenced to either a participant or beneficiary as of the effective date of the suspension. If the participant is alive on the effective date, the participant is treated as having commenced benefits on the effective date. If the participant is deceased on the effective date, the beneficiary is treated as having commenced benefits on the effective date.

The final regulations provide that if the age-based limitation applies to a participant on the effective date of the suspension then the age-based limitation also applies to the beneficiary of the participant. For purposes of this rule, the age-based limitation applies to the beneficiary based on the age of the participant as of the end of the month that includes the effective date of the suspension.

The final regulations provide that the age-based limitation applies to a suspension of benefits in which an alternate payee has an interest, whether or not the alternate payee has commenced benefits as of the effective date of the suspension. If the alternate payee's right to the suspended benefits derives from a qualified domestic relations order within the meaning of section 414(p)(1)(A) (QDRO) under which the alternate payee shares in each benefit payment but the participant retains the right to choose the time and form of payment with respect to the benefit to which the suspension applies (shared payment QDRO), the final regulations provide that the applicable percentage for the alternate payee is calculated by using the participant's age as of the end of the month that includes the effective date of the suspension. If the alternate payee's right to the suspended benefits derives from a QDRO under which the alternate payee has a separate right to receive a portion of the participant's retirement benefit to be paid at a time and in a form different from that chosen by the participant (separate interest QDRO), the final regulations provide that the applicable percentage for the alternate payee is calculated by substituting the alternate payee's age as of the end of the month that includes the effective date of the suspension for the participant's age.

The provisions of the final regulations regarding the age-based limitation are generally the same as provisions of the 2015 regulations, except that the final regulations clarify that, with respect to a benefit payable to a beneficiary or alternate payee the relevant date for determining the age of a participant, beneficiary, or alternate payee, as applicable, is the end of the month that includes the effective date of the suspension, rather than the effective date of the suspension.

B. *Aggregate limitations*

1. Suspension Necessary to Avoid Insolvency

The final regulations reflect the statutory requirement in section 432(e)(9)(D)(iv) that any suspension of benefits in the aggregate (considered, if applicable, in combination with a partition of the plan) must be at a level that is reasonably estimated to enable the plan to avoid insolvency. With respect to this requirement, the final regulations are the same as the 2015 regulations, with a minor clarification.

The final regulations provide that a suspension of benefits (considered, if applicable, in combination with a partition of the plan) satisfies the requirement that it is at a level that is reasonably estimated to enable the plan to avoid insolvency if: (1) For each plan year throughout an extended period beginning on the first day of the plan year that includes the effective date of the suspension, the plan's solvency ratio is projected on a deterministic basis to be at least 1.0; (2) based on stochastic projections reflecting variance in investment return, the probability that the plan will avoid insolvency throughout the extended period is more than 50 percent; and (3) unless the plan's projected funded percentage at the end of the extended period using the deterministic projection exceeds 100 percent, the projection shows that during each of the last five plan years of that period, neither the plan's solvency ratio nor its available resources is projected to decrease.[5] In the case of a plan that is not large enough to be required to select a retiree representative (that is, a plan with fewer than 10,000 participants), the stochastic projection is not required.

For these purposes, a plan's solvency ratio for a plan year means the ratio of the plan's available resources for the plan year to the scheduled benefit payments under the plan for the plan year. An extended period means a period of at least 30 plan years. However, in the case of a temporary suspension of benefits that is scheduled to cease as of a date that is more than 25 years after the effective date of the suspension, the extended period must be lengthened so that it ends no earlier than five plan years after the cessation of the suspension.

2. Suspension Not Materially in Excess of Level Necessary to Avoid Insolvency

The final regulations provide rules for applying the statutory requirement under section 432(e)(9)(D)(iv) that any suspension of benefits must be at a level that does not materially exceed the level necessary to enable the plan to avoid insolvency. Under the 2015 regulations, a proposed suspension of benefits would satisfy this requirement only if an alternative, similar but smaller, suspension of benefits would not be sufficient to enable the plan to satisfy the requirement that the suspension be at a level that is reasonably estimated to enable the plan to avoid insolvency. This alternative suspension would be one under which the dollar amount of the suspension for each participant and beneficiary is reduced by five percent.

For example, if, under the original proposed suspension, a participant's benefit were reduced by $1,400, from $3,000 per month to $1,600 per month, then the amount of the alternative similar, but smaller suspension would be $1,330 ($1,400 minus 5% of $1,400) and the resulting monthly benefit would be $1,670 ($3,000 minus $1,330). As another example, if, under the original proposed suspension, a participant's benefit were reduced by $500, from $3,000 per month to $2,500 per month, then the amount of the alternative similar, but smaller suspension would be $475 ($500 minus 5% of $500) and the resulting monthly benefit would be $2,525 ($3,000 minus $475).

The use of five percent for this purpose is roughly comparable to the common use in accounting standards of a five-percent threshold for materiality and strikes a balance between two policy concerns raised by commenters. One concern is that, if a suspension ultimately proves larger than necessary to avoid insolvency, then a smaller suspension could have preserved the solvency of the plan while imposing less onerous benefit cuts. Another concern is that, if a suspension proves insufficient to allow the plan to avoid insolvency, then a second suspension may be needed. The margin by which a suspension can exceed the amount necessary to avoid insolvency while not materially exceeding that amount reflects a balancing of these two concerns. Some commenters maintained that the five-percent margin in the 2015 regulations is too large and would have the effect of permitting excessive suspensions. Other commenters maintained that the five-percent margin is too narrow, especially in the case of a smaller benefit suspension, because a narrow margin increases the risk that actuarial losses will cause a suspension to prove insufficient for the plan to avoid insolvency.

After consideration of these comments, the Treasury Department and the IRS believe that a five percent margin generally strikes a reasonable balance between the competing policy concerns, but that a better balance between these policy concerns is achieved by increasing the margin in the case of a suspension below a certain size. Accordingly, the final regulations modify this standard by adding a floor to the five-percent margin of two percent of the periodic payment determined without regard to the proposed reduction, a change which will increase the margin in the case of a somewhat smaller benefit suspension. Thus, under the final regulations the alternative, similar but smaller suspension that is used for this purpose is one in which the amount of the proposed reduction in the periodic payment (determined after application of the individual limitations) is decreased (but not below zero) by the greater of five percent of the proposed reduction or two percent of the periodic payment determined without regard to the proposed reduction. Applying this standard to the earlier example under which a participant's benefit was reduced by $500, from $3,000 per month to $2,500 per month, then the amount of the alternative, similar but smaller suspension would be $440 ($500 minus 2% of $3,000), rather than $475 ($500 minus 5% of $500), and the resulting monthly benefit would be $2,560 ($3,000 minus $440), rather than $2,525. Thus, the difference between the monthly benefit under proposed suspension and the monthly benefit under the alternative, similar but smaller suspension would be $60 (rather than $25).

In addition, the final regulations clarify that the extended period used to demonstrate that the proposed suspension does not materially exceed the level that is reasonably estimated to enable the plan to avoid insolvency must be no shorter than the period used for the demonstration that the proposed suspension is reasonably estimated to avoid insolvency.

3. Actuarial Basis for Projections

The final regulations generally adopt the provisions of the 2015 regulations regarding the actuarial basis for projections, with certain clarifications in response to comments. The final regulations require the actuarial projections used for purposes of these requirements to reflect the assumption that the suspension of benefits continues indefinitely (or, if the suspension expires on a specified date by its own terms, until that date). Further, the final regulations provide that the actuary's selection of assumptions about future covered employment and contribution levels (including contribution base units and average contribution rate) is permitted to be

[5] The term "available resources" is defined in section 418E(b)(3). Under that provision, a plan's available resources are generally equal to the beginning-of-year assets adjusted for the expected cash flow for the plan year (other than benefit payments).

based on information provided by the plan sponsor, which must act in good faith in providing the information. Finally, the final regulations provide that, to the extent that an actuarial assumption used for the projections differs from that used to certify whether the plan is in critical and declining status pursuant to section 432(b)(3)(B)(iv), an explanation of the information and analysis that led to the selection of that different assumption must be provided.

The final regulations clarify the standards that apply to actuarial assumptions to be used in actuarial projections. The 2015 regulations require that the actuarial assumptions and methods used for the actuarial projections be reasonable in accordance with the rules of section 431(c)(3). The final regulations replace that reference with a specific requirement that each of the actuarial assumptions and methods used, and the combination of those actuarial assumptions and methods, must be reasonable, taking into account the experience of the plan and reasonable expectations. This standard is similar to the standard under section 431(c)(3) requiring that each of the actuarial assumptions and methods be reasonable and that the combination of those assumptions and methods offer the actuary's best estimate of anticipated experience.

The final regulations also specify that, to be reasonable, the actuarial assumptions and methods must be appropriate for the purpose of the measurement.[6] This means, among other things, that factors specific to the measurements must be taken into account in selecting the assumptions and methods. These measurements (that is, the cash flow projections) will be used to demonstrate compliance with a requirement that must be satisfied before a plan in critical and declining status is permitted to reduce participant and beneficiary benefits, under circumstances in which the reduction will not automatically be adjusted if actual experience differs from projections. Moreover, such a plan's asset levels typically are projected to decline during the earlier years of the projections, even after reflecting the proposed benefit suspension. For example, actuarial assumptions for the rate of investment return normally would not be appropriate for the purpose of projecting cash flows in order to estimate whether a plan in critical and declining status will avoid insolvency if those assumptions were developed in a manner that fails to take into account the anticipated pattern and magnitude of changes in the level of plan assets during the projection period. This is because the use of an investment return assumption derived from a time-weighted average of the expected rates of return for the entire projection period would not result in an appropriate projection of the expected dollar amount of investment return over that period to the extent anticipated rates of return are expected to be smaller or larger during the portion of that period when the level of plan assets is expected to be relatively higher. Thus, it would not be appropriate to develop an actuarial assumption for the rate of investment return based solely on long-term expectations without taking these differences into account.[7]

Like the 2015 regulations, the final regulations require cash flow projections to be based on the fair market value of assets as of the end of the calendar quarter immediately preceding the date the application is submitted, projected benefit payments that are consistent with the projected benefit payments under the most recent actuarial valuation, and appropriate adjustments to projected benefit payments to include benefits for new hires that are reflected in the projected contribution amounts. The final regulations provide that the projected cash flows relating to contributions, withdrawal liability payments, and benefit payments must also be adjusted to reflect significant events that occurred after the most recent actuarial valuation. For this purpose, significant events include: (1) A plan merger or transfer; (2) the withdrawal or the addition of employers that changed projected cash flows relating to contributions, withdrawal liability payments, or benefit payments by more than five percent; (3) a plan amendment, a change in a collective bargaining agreement, or a change in a rehabilitation plan that changed projected cash flows relating to contributions, withdrawal liability, or benefit payments by more than five percent; or (4) any other event or trend that resulted in a material change in those projected cash flows.

A number of comments were received regarding the actuarial projections required as part of the application for suspension. As described subsequently, these projections include not only a demonstration that the plan would avoid insolvency but also a demonstration of what would happen if the plan were to have less favorable experience, such as a lower investment return.

Some commenters thought too much information was required, resulting in the expenditure of excessive time and plan resources. Others thought too little information was required and suggested requiring additional information (such as the extent to which contributions are used to pay for past benefits rather than for current accruals). The Treasury Department and the IRS have reviewed these comments and have concluded that this information is valuable to the Treasury Department for purposes of evaluating whether a suspension is reasonably estimated to enable the plan to avoid insolvency. This information is also informative for participants and beneficiaries in deciding whether to vote to accept or reject the suspension.[8] The value of this information to the Treasury Department and to participants and beneficiaries outweighs the burden of providing this information. Accordingly, no changes have been made to the regulations with respect to the scope of the required actuarial projections.

Under the final regulations, an application for suspension must include a disclosure of the total contributions, total contribution base units and average contribution rate, withdrawal liability

[6]Actuarial Standards of Practice (ASOPs) are issued by the Actuarial Standards Board and are available at http://www.actuarialstandardsboard.org/standards-of-practice. Certain ASOPs, including ASOPs Nos. 4, 27, and 35, are relevant to the actuary's selection of assumptions.

[7]Methods for developing an assumption for the rate of return that would be appropriate for purposes of the measurement include: (1) Using a select and ultimate assumption that includes different assumptions of investment returns for different portions of the projection period, or (2) developing a return assumption based on dollar-weighted returns over the projection period.

[8]For example, a projection demonstrating that the plan would not avoid insolvency if it were to experience a lower rate of return helps participants to understand that the actuarial projections in the application are subject to uncertainty.

payments, and the rate of return on plan assets for each of the 10 plan years preceding the plan year in which the application is submitted. In addition, an application must include an illustration, prepared on a deterministic basis, of the projected value of plan assets, the accrued liability of the plan (calculated using the unit credit funding method), and the funded percentage for each year in the extended period.

The final regulations also require that an application include deterministic projections of the plan's solvency ratio over the extended period using two alternative assumptions that the plan's future rate of return was lower than the assumed rate of return by (1) one percentage point and (2) two percentage points. In addition, the final regulations adopt the provisions from the 2015 regulations that provide that an application must include deterministic projections of the plan's solvency ratio over the extended period using two alternative assumptions for future contribution base units. These alternatives are that future contribution base units: (1) Continue under the same trend as the plan experienced over the past 10 years, and (2) continue under that 10-year trend reduced by one percentage point. However, with respect to calculating the sensitivity of actuarial projections to the assumptions of future contribution base units, the final regulations clarify that it is permissible for the projections to be made without reflecting any adjustments to the projected benefit payments that result from those alternative assumptions regarding future contribution base units.

4. Equitable Distribution of Suspension

The rules under the final regulations regarding the equitable distribution requirement are generally the same as the rules under the 2015 regulations. The final regulations require any suspension of benefits to be equitably distributed across the participant and beneficiary population. If a suspension of benefits provides for different treatment for different participants and beneficiaries, then the suspension of benefits is equitably distributed across the participant and beneficiary population only if: (1) Under the suspension, the participants and beneficiaries are divided into separate categories or groups that are defined by the consistent treatment of individuals within each separate category or group; (2) any difference in the treatment under the suspension among the different categories or groups is based on relevant factors reasonably selected by the plan sponsor; and (3) any such difference in treatment is based on a reasonable application of those relevant factors. With respect to a reasonable application of the relevant factors, the final regulations provide that it would be unreasonable to apply a factor or factors in a manner that is inconsistent with the protections provided by the individual limitations under section 432(e)(9)(D), such as protections for older individuals or individuals with benefits that are closer to the PBGC guarantee level.

The final regulations contain new rules to clarify when different groups of participants and beneficiaries are treated as separate categories or groups for purposes of applying the equitable distribution requirement in the case of a proposed suspension of benefits under which an individual's benefits after suspension are calculated under a new benefit formula (rather than by reference to an individual's benefits before suspension). In this case, the evaluation of whether the proposed suspension is equitably distributed across the participant and beneficiary population is based on a comparison of an individual's pre-suspension benefit to the individual's post-suspension benefit (determined without regard to the application of the individual limitations). Accordingly, all individuals whose pre-suspension benefits are determined under a uniform pre-suspension benefit formula and whose post-suspension benefits are determined under a different uniform post-suspension benefit formula are treated as a single group. The final regulations clarify the application of this rule in the case of different pre-suspension benefit formulas with respect to different plan years. In addition, the final regulations clarify that two individuals are not treated as having different pre-suspension or post-suspension benefit formulas merely because, as a result of the application of a uniform set of early retirement factors, their benefits differ because of retirement at different ages.

The final regulations include a number of examples that illustrate the equitable distribution rules, most of which were included in the 2015 regulations. One new example illustrates that plan sponsors may consider factors other than the statutory factors in determining whether a distribution of the suspension is equitable, provided that the factor is consistent with the general conditions and limitations required for a suspension to satisfy section 432(e)(9).[9] Under this example, a plan sponsor applies a smaller reduction to individuals who are receiving disability benefits under the Social Security Act (even though they are not receiving benefits based on disability under the plan) than to similarly situated individuals. The example concludes that, under the facts, the suspension of benefits is equitably distributed. Although this example illustrates a suspension under which individuals receiving Social Security disability benefits receive favorable treatment (which is a standard that is easily administrable), a suspension could instead be designed using another reasonable definition of disability for this purpose.

5. Specific Limitation on Suspension for Certain Plans

The final regulations reserve a paragraph for rules relating to the application of section 432(e)(9)(D)(vii), which contains a specific limitation on how a suspension of benefits must be applied under a plan that includes benefits that are directly attributable to a participant's service with any employer that has, prior to December 16, 2014, withdrawn from the plan in a complete withdrawal under section 4203 of ERISA, paid the full amount of the employer's withdrawal liability under section 4201(b)(1) of ERISA or an agreement with the plan, and, pursuant to a collective bargaining agreement, assumed liability for providing benefits to participants and beneficiaries of the plan under a separate, single-employer plan sponsored by the employer, in an amount

[9]Thus, a suspension is permitted to provide for different treatment of participants whose employers are in different withdrawal liability pools that have been approved by PBGC.

equal to any amount of benefits for these participants and beneficiaries reduced as a result of the financial status of the plan. The Treasury Department and the IRS expect to adopt final regulations under section 432(e)(9)(D)(vii) after consideration of comments received in response to the 2016 regulations and the public hearing on those regulations.

VI. *Benefit Improvements*

The final regulations generally adopt the provisions set forth in the 2015 regulations for the application of section 432(e)(9)(E), regarding benefit improvements. Under the final regulations, a plan satisfies the criteria in section 432(e)(9)(E) only if, during the period that any suspension of benefits remains in effect, the plan sponsor does not implement any benefit improvement except as provided in the final regulations.

The final regulations define the term benefit improvement to mean, with respect to a plan, a resumption of suspended benefits, an increase in benefits, an increase in the rate at which benefits accrue, or an increase in the rate at which benefits become nonforfeitable under the plan. In the case of a suspension of benefits that expires as of a date that is specified in the original plan amendment providing for the suspension, the resumption of benefits solely from the expiration of that period is not treated as a benefit improvement.

A. *Limitations on benefit increases for those not in pay status*

The final regulations provide that, during the period any suspension of benefits under a plan remains in effect, the plan sponsor may not increase the liabilities of the plan by reason of any benefit improvement for any participant or beneficiary who was not in pay status by the first day of the plan year for which the benefit improvement takes effect, unless several conditions are satisfied.

The final regulations include conditions that must be satisfied for the benefit improvement to take effect. The final regulations require that the present value of the total liabilities for a benefit improvement for participants and beneficiaries in pay status (that is, those whose benefit commencement dates occurred before the first day of the plan year for which the benefit improvement takes effect) is not less than the present value of the total liabilities for a benefit improvement for participants and beneficiaries who were not in pay status by that date. For this purpose, the final regulations provide that the present value is the present value as of the first day of the plan year in which the benefit improvement is proposed to take effect and clarify that the actuarial assumptions and methods used for the actuarial projections that are required must each be reasonable, and the combination of the actuarial assumptions and methods must be reasonable, taking into account the experience of the plan and reasonable expectations. In addition, the final regulations clarify that, in the case of a benefit increase that is an increase in the rate of future accrual, the calculation of present value of the liabilities for the benefit improvements must take into account the increase in accruals for current participants for all future years.

As under the 2015 regulations, the final regulations require that the plan sponsor must also equitably distribute the benefit improvement among participants and beneficiaries whose benefit commencement dates occurred before the first day of the plan year in which the benefit improvement is proposed to take effect. The evaluation of whether a benefit improvement is equitably distributed must take into account the factors relevant to whether a suspension of benefits is equitably distributed, described elsewhere in this preamble, and the extent to which the benefits of the participants and beneficiaries were suspended.

Pursuant to section 432(e)(9)(E)(i)(II), the final regulations require the plan actuary to certify that, after taking into account the benefit improvement, the plan is projected to avoid insolvency indefinitely. The final regulations require that this certification be made using the standards that apply for purposes of determining whether a suspension is sufficient to avoid insolvency that are described in this preamble.

The final regulations provide that these limitations do not apply to a resumption of suspended benefits or plan amendment that increases liabilities with respect to participants and beneficiaries not in pay status by the first day of the plan year in which the benefit improvement took effect that: (1) The Treasury Department, in consultation with PBGC and the Labor Department, determines to be reasonable and which provides for only *de minimis* increases in plan liabilities, or (2) is required as a condition of qualification under section 401 or to comply with other applicable law, as determined by the Treasury Department.

B. *Limitations on benefit increases for those in pay status*

Under final regulations, as under the 2015 regulations, the plan sponsor may increase liabilities of the plan by eliminating some or all of the suspension that applies solely to participants and beneficiaries in pay status at the time of the resumption, provided that the plan sponsor equitably distributes the value of those resumed benefits among participants and beneficiaries in pay status, taking into account factors relevant to whether a suspension of benefits is equitably distributed. Such a resumption of benefits is not subject to the limitations on a benefit improvement under section 432(f) (relating to restrictions on benefit increases under plans in critical status).

C. *Other limitations on benefit increases*

The final regulations provide that the limitations on benefit improvements generally apply in addition to other limitations on benefit increases that apply to a plan. These limitations on benefit improvements are in addition to the limitations in section 432(f) and any other applicable limitations on increases in benefits imposed on a plan. These limitations on benefit improvements do not apply in the case of benefits paid following the scheduled expiration of a temporary suspension of benefits.

One commenter asked that benefit improvements under other plans be treated in the same manner as benefit improvements under the plan at issue for purposes of satisfying the requirement that retirees be given at least as much as active participants with respect to benefit improvements. Such a requirement would not be consistent with the terms of section 432(e)(9)(E), and, therefore, the final regulations do not adopt this suggestion. However, any actions that increase liabilities with respect to a group or groups of individuals subject to the suspension, even if under another plan, would result in a use of resources that must be taken into account in the annual plan sponsor determination of whether all reasonable measures have been and continue to be taken to avoid insolvency.

VII. *Notice of Proposed Suspension*

Section 432(e)(9)(F)(iii) states that notice must be provided in a form and manner prescribed in guidance and that notice may be provided in written, electronic, or other appropriate form to the extent such form is reasonably accessible to persons to whom the notice is required to be provided.

The final regulations prescribe rules implementing the statutory notice requirements in section 432(e)(9)(F) that are generally the same as the rules set forth in the 2015 regulations. The final regulations require the plan sponsor to provide notice of a proposed suspension to: (i) All plan participants, beneficiaries of deceased participants, and alternate payees (regardless of whether their benefits are proposed to be suspended), except those who cannot be contacted by reasonable efforts; (ii) each employer that has an obligation to contribute (within the meaning of section 4212(a) of ERISA) under the plan; and (iii) each employee organization that, for purposes of collective bargaining, represents plan participants employed by such an employer.

The 2015 regulations contain two examples illustrating the efforts that constitute reasonable efforts to contact individuals for purposes of this notice requirement. In response to comments, these examples have been modified in the final regulations to describe in more detail the steps taken to locate participants whose notices were returned as undeliverable. These steps include contacting administrators of any other employee benefit plans (such as, to the extent such contact is permitted under applicable law, the administrators of a health fund or an apprenticeship training fund) for contact information regarding a missing individual. As in the 2015 regulations, these examples demonstrate that it is not sufficient to merely send notices to the individuals' last known mailing addresses.

The final regulations state that, to satisfy the statutory requirement that the notice contain sufficient information to enable plan participants and beneficiaries to understand the effect of the suspension of benefits, the notice must contain the following items:

- An individualized estimate, on an annual or monthly basis, of the effect of the suspension on the participant or beneficiary. However, to the extent it is not possible to provide an individualized estimate on an annual or monthly basis of the quantitative effect of the suspension on the participant or beneficiary, such as in the case of a suspension that affects the payment of a future cost-of-living adjustment, that effect may be reflected in a narrative description;
- A statement that the plan sponsor has determined that the plan will become insolvent unless the proposed suspension (and, if applicable, the proposed partition) takes effect, and the year in which insolvency is projected to occur without a suspension of benefits (and, if applicable, a proposed partition);
- A statement that insolvency of the plan could result in benefits lower than benefits paid under the proposed suspension and a description of the projected benefit payments upon insolvency;
- A description of the proposed suspension and its effect, including a description of the different categories or groups affected by the suspension, how those categories or groups are defined, and the formula that is used to calculate the amount of the proposed suspension for individuals in each category or group;
- A description of the effect of the proposed suspension on the plan's projected insolvency;
- A description of whether the suspension will remain in effect indefinitely or the date the suspension will expire if it will expire by its own terms; and
- A statement describing the right to vote on the suspension application.

The final regulations provide that the notice of proposed suspension may not include false or misleading information (or omit information so as to cause the information provided to be misleading). The notice is permitted to include additional information, including information relating to an application for partition under section 4233 of ERISA, provided that it satisfies the requirement to not provide false or misleading information.

The notice of proposed suspension must be written in a manner so as to be understood by the average plan participant.[10] The regulations provide that the Treasury Department will provide a model notice. The use of the model notice will satisfy the content requirement and the readability requirement with respect to the language provided in the model.

The final regulations provide that notice may be provided in writing. It may also be provided in electronic form to the extent that the form is reasonably accessible to persons to whom the notice is required to be provided. Permissible electronic methods include those permitted under regulations of the Department of Labor at 29 CFR § 2520.104b–1(c) and those described at § 54.4980F–1, Q&A–13(c) of the Excise Tax Regulations.

Section 432(e)(9)(F) provides that the notice of proposed suspension must be given "concurrently" with the submission of an application to the Treasury Department, but does not specify a precise timeframe for satisfying this requirement. An interpretation that "concurrently" means either simultaneously or on the same day was rejected because it would require the difficult synchronization of the plan sponsor's electronic submission of its application and its giving of notice in written and/or in electronic form. As described in section VIII of this preamble, the final regulations require a plan sponsor to submit its application electronically, but, as described previously in this section of the preamble, the final regulations also allow a plan sponsor to give notice by mail. Therefore, the final regulations interpret

[10]See 29 C.F.R. § 2520.102–2 of the Department of Labor regulations for rules under a similar standard applicable to summary plan descriptions.

"concurrently" to permit the sponsor to provide written notice a few days earlier than the electronic submission of the application (in order for the mailed notice and application to be received on or about the same date). The final regulations thus permit a plan sponsor to give notice no earlier than four business days before the submission of its application.

The final regulations also provide that a plan sponsor is permitted to give written notice no later than two business days after the Treasury Department notifies the plan sponsor that it has submitted a complete application. This allows a plan sponsor a maximum of four business days following its submission of an application to provide the required notices. This four-business-day period of time enables the Treasury Department to make a preliminary completeness check of the application during the first two business days, and the plan sponsor two business days thereafter to give the required notices.[11] This approach will help participants by minimizing the risk of confusion and plan expense. For example, if a plan sponsor submits an incomplete application, compiles the additional information, and then finds the individualized estimates that the plan sponsor already gave to be inaccurate (or simply takes too long to compile the additional information), the plan sponsor would have to re-send the notices, increasing the likelihood that the notice would not be understood by the average plan participant as a result of receiving two different notices, each with a different individualized estimate. The Treasury Department encourages plan sponsors to delay giving notice until after the Treasury Department provides notification that the application is complete. If additional individuals who are entitled to notice are located after the deadline for providing notice then the plan sponsor must give those newly located individuals notice as soon as practicable after they are located.

In accordance with section 432(e)(9)(F)(iv), the final regulations provide that a notice of proposed suspension satisfies the requirement for notice of a significant reduction in benefits described in section 4980F that would otherwise be required as a result of that suspension of benefits. To the extent that other reductions accompany a suspension of benefits, such as a reduction in the future accrual rate described in section 4980F for active participants or a reduction in adjustable benefits under section 432(e)(8), notice that satisfies the requirements (including the applicable timing requirements) of section 4980F or section 432(e)(8), as applicable, must be provided.

VIII. *Approval or Denial of an Application for Suspension of Benefits*

The final regulations generally adopt the provisions of the 2015 regulations under which the plan sponsor of a plan in critical and declining status for a plan year that seeks to suspend benefits must submit an application for approval of the proposed suspension of benefits to the Treasury Department. The Treasury Department, in consultation with PBGC and the Labor Department, will approve a complete application upon finding that: (1) The plan is eligible for the suspension; (2) the plan actuary and plan sponsor have satisfied the requirements of section 432(e)(9)(C), (E), and (F); and (3) the design of the suspension satisfies the criteria of section 432(e)(9)(D). The Treasury Department's approval of the design of the suspension of benefits does not constitute approval of any individual benefit calculation for any participant or beneficiary.

The final regulations provide that additional guidance that may be necessary or appropriate with respect to applications, including procedures for submitting applications and the information required to be included in a complete application, may be issued in the form of revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin. The guidelines and procedures for submitting an application that were set forth in Rev. Proc. 2015–34 have been updated in Rev. Proc. 2016–xx.

The final regulations provide that a complete application will be deemed approved unless, within 225 days after a complete application is received, the Treasury Department notifies the plan sponsor that its application does not satisfy one or more of the requirements for approval. The final regulations provide that, if necessary under the circumstances, the Treasury Department and the plan sponsor may mutually agree in writing to stay the 225-day period. It is expected that any such agreement would be entered into only in unusual circumstances.

The final regulations provide, as required by section 432(e)(9)(G)(iv), that, in evaluating whether the plan sponsor has satisfied the condition (in section 432(e)(9)(C)(ii)) that it determine that all reasonable measures to avoid insolvency within the meaning of section 418E have been taken, the Treasury Department, in consultation with PBGC and the Labor Department, will review the plan sponsor's consideration of each of the factors enumerated in section 432(e)(9)(C)(ii) and each other factor it took into account in making that determination. The final regulations do not require the plan sponsor to take any particular measure or measures to avoid insolvency but do require, in the aggregate, that the plan sponsor take all reasonable measures to avoid insolvency. As required by section 432(e)(9)(G)(v), in evaluating a plan sponsor's application, the Treasury Department will accept the plan sponsor's determinations under section 432(e)(9)(C)(ii), unless the Treasury Department concludes, in consultation with PBGC and the Labor Department, that the determinations were clearly erroneous. This statutory structure reflects the view that particular measures to avoid insolvency may be inappropriate for some plans and requires the Treasury Department to review the plan sponsor's consideration of the appropriateness of each of the statutory factors, but recognizes that the plan sponsor is generally in a better position than the Treasury Department to determine the most effective measures that a particular plan should take to avoid insolvency.

The final regulations provide that an application to suspend benefits will not be approved unless the plan sponsor certifies that, if it receives final authorization to suspend benefits, chooses to implement the suspension, and adopts a plan amendment to implement the suspension, it will timely amend the plan to provide that: (1)

[11] The completeness check is described in section VIII of this preamble.

The suspension of benefits will cease as of the first day of the first plan year following the first plan year in which the plan sponsor fails to make the annual determinations in section 432(e)(9)(C)(ii), and (2) any future benefit improvement must satisfy the section 432(e)(9)(E) rules for benefit improvements.

An application must be submitted electronically in a searchable format. The final regulations provide that, after receiving a submission, the plan sponsor will be notified within two business days whether the submission constitutes a complete application. If the submission is a complete application, the application will be treated as submitted on the date it was originally submitted to the Treasury Department. If a submission is incomplete, the notification will inform the plan sponsor of the information that is needed to complete the submission and give the plan sponsor a reasonable opportunity to submit a complete application. In such a case, the complete application will be treated as submitted on the date the additional information needed to complete the application is submitted to the Treasury Department.

The final regulations provide that in the case of a plan sponsor that is not submitting an application for suspension in combination with an application to PBGC for a plan partition, the application for suspension generally will not be accepted unless the proposed effective date of the suspension is at least nine months after the date on which the application is submitted. However, in appropriate circumstances, an earlier effective date may be permitted. Appropriate circumstances could include an application for a proposed suspension that is a revision of a previously proposed suspension.

Some commenters asserted that an earlier effective date of a suspension should be permitted because the size of the benefit cuts pursuant to the suspension might be smaller with an earlier effective date. The purpose of the general nine month requirement is to ensure adequate time to review the proposed suspension without a need to delay the effective date of the proposed suspension. Deferring the original effective date could have other repercussions on the proposed suspension, including confusion for plan participants and beneficiaries. Furthermore, deferring the effective date would change the economics of the suspension. For example, it could result in the application of the age-based limitation to additional participants. This in turn could lead to greater reductions in the benefits of other individuals in order to satisfy the requirement that the suspension, in the aggregate, be reasonably estimated to achieve, but not materially exceed, the level necessary to avoid insolvency. Accordingly, no change has been made in the final regulations to this provision.

In the case of an application for suspension in combination with an application for partition, the impact of a delayed effective date for the suspension would be the potential that PBGC's ability to provide the plan with sufficient financial assistance to keep the plan solvent would be impaired (rather than a redesign of the suspension). Accordingly, the final regulations do not require the proposed effective date of such a suspension to be at least nine months after the date on which the application is submitted.

The final regulations provide that, in any case in which a suspension of benefits with respect to a plan is made in combination with a partition of the plan under section 4233 of ERISA, the suspension of benefits is not permitted to take effect prior to the effective date of the partition. This requirement will not be satisfied if the partition order under section 4233 of ERISA has not been provided to the Treasury Department by the last day of the 225-day review period described in section 432(e)(9)(G)(iii), after which deemed approval of the suspension would occur. The final regulations clarify that a conditional approval by PBGC of a partition application that is conditioned only on the Treasury Department's issuing a final authorization to suspend is treated as a partition order.

The final regulations generally adopt other provisions from the 2015 regulations, with respect to the application process. The final regulations provide that, no later than 30 days after receiving a complete application, the application will be published on the website of the Department of the Treasury, and the Treasury Department will publish a notice in the **Federal Register** soliciting comments from contributing employers, employee organizations, and participants and beneficiaries of the plan for which an application was made, and other interested parties. In addition, the final regulations provide that the notice soliciting comments will generally request that comments be submitted no later than 45 days after publication of that notice in the **Federal Register**, but the notice may specify a different deadline for comments in appropriate circumstances. (Circumstances under which a shorter comment period may be appropriate include the receipt of an application for a proposed suspension that is a revision of a previously proposed suspension.) Comments received in response to such a solicitation will be made publicly available.

The final regulations include a new rule that, in appropriate circumstances, the Treasury Department may permit a plan sponsor that has withdrawn an application to submit a revised application for suspension that will be subject to a different review process (referred to in the regulations as the resubmission review process). The Treasury Department will follow the same procedures and apply the same standards in the resubmission review process as in the review of any other application, except: (1) The revised application would be permitted to propose an effective date of the suspension that is less than nine months after the revised application is submitted; (2) the individual and aggregate limitations under section 432(e)(9)(D) may be applied using the same actuarial data (including the same fair market value of the plan assets) as was used in the initial application; and (3) the plan sponsor would be permitted to provide a simplified version of the notice of the revised application to any individual for whom the amount and timing of the proposed suspension under the revised application are the same as under the withdrawn application.

Whether to make the resubmission review process available for a particular application is within the Treasury Department's discretion, in consultation with PBGC and the Labor Department. In determining whether there are appropriate circumstances that warrant the resubmission review process, the Treasury Department will, for example, evaluate whether such resubmission review would enable it to make significant use of its prior analysis of the withdrawn application. Specifically, the Treasury Department expects to take into consideration one or more factors, including: (1) The extent to which the Treasury Department, in consultation with PBGC and the Labor Department, had evaluated the application prior to withdrawal; (2) the amount of time that has or will have elapsed since the submission of the withdrawn application; and (3) the extent to which the experience of the plan has been different than expected since the submission of the withdrawn application, including the extent of changes in the fair market value of plan assets, changes in the number of disabled participants (as defined under the plan), or withdrawals or bankruptcy proceedings filed by employers contributing to the plan.

As under the 2015 regulations, the final regulations provide that if the Treasury Department denies a plan sponsor's application, the notification of the denial will detail the specific reasons for the denial, including reference to the specific requirement not satisfied. If the Treasury Department approves a plan sponsor's application and expects that the plan is a systemically important plan, then the Treasury Department will notify the plan sponsor of that expectation and that the plan sponsor will be required to provide individual participant data and actuarial analysis upon request. This information would be used in the event the vote results in the rejection of the suspension and would assist the Treasury Department in determining whether to permit an implementation of the rejected suspension or a modification of that suspension.

The final regulations provide that the Secretary of the Treasury may appoint a Special Master for purposes of section 432(e)(9). If a Special Master is appointed, the Special Master will be an employee of the Department of the Treasury, will coordinate the implementation of the regulations and the review of applications for the suspension of benefits and other appropriate documents, and will provide recommendations to the Secretary of the Treasury with respect to decisions required under these regulations.

## IX. *Participant Vote on Proposed Benefit Reduction*

A participant vote requires the completion of three steps. First, a package of ballot materials is distributed to eligible voters. Second, the eligible voters cast their votes and the votes are collected and tabulated. Third, the Treasury Department (in consultation with PBGC and the Labor Department) determines whether a majority of the eligible voters has voted to reject the proposed suspension.

### A. *Eligible voters and voting roster*

The 2015 regulations define the term "eligible voters" as all plan participants and all beneficiaries of deceased participants. Some commenters noted that the reference to participants in this provision could be interpreted as referring only to active participants. Accordingly, these final regulations clarify that eligible voters include terminated vested participants and retirees (but not alternate payees).

These final regulations add the term "voting roster" to describe the list of eligible voters to whom the ballot must be sent. The plan sponsor must prepare the voting roster that includes those eligible voters to whom the notices were sent. If there is a plan participant or beneficiary who did not receive a notice but who is subsequently located by the plan sponsor, the final regulations require that individual to be included on the voting roster. Similarly, if an individual becomes a plan participant after the date the notices were sent, then the individual must be included on the voting roster. If a plan sponsor learns that an eligible voter has died, then that deceased individual must not be included on the voting roster (but if that participant has a beneficiary entitled to benefits under the plan, the beneficiary must be included on the roster).

### B. *Service provider may be designated*

As under the 2015 regulations, these final regulations provide that the Treasury Department is permitted to designate a service provider or service providers to facilitate the administration of the vote. The service provider may assist in the steps of distributing the ballot package to eligible voters and collecting and tabulating the votes. If a service provider is designated to collect and tabulate votes, then the service provider will provide the Treasury Department with the report of the results of the vote, which includes an accounting of the number of eligible voters who voted, the number of eligible voters who voted in support of and to reject the suspension, and certain other information.

### C. *Ballots and other plan sponsor communications*

These final regulations set forth rules regarding the ballot package that is sent to eligible voters and the plan sponsor's responsibilities relating to ballots and related communications to participants and beneficiaries. The final regulations provide that the ballot must be approved by the Treasury Department, in consultation with PBGC and the Labor Department, and that the ballot must be written in a manner that can be readily understood by the average plan participant and may not include any false or misleading information. Under the final regulations, the ballot package sent to eligible voters includes the approved ballot and a voter identification code for each eligible voter. The voter identification code, which is assigned by the Treasury Department or a designated service provider, is intended to ensure the validity of the vote while maintaining the eligible voters' privacy in the voting process.

These final regulations provide guidance on the plan sponsor's statutory requirement to provide a ballot. Because the ballot for each eligible voter is accompanied by a voter identification code, the plan sponsor cannot directly distribute the ballots. Instead, the plan sponsor is responsible for furnishing the voting roster so that the Treasury Department or its designated service provider can distribute the ballots on the plan sponsor's behalf. For each eligible voter on the voting roster, the plan sponsor must include the last known mailing address (except with respect to those eligible voters for whom the last known mailing address is known to be incorrect). The plan sponsor must also provide a list of eligible voters whom the plan sponsor has been unable to locate using reasonable efforts. In addition, the plan sponsor must furnish current electronic mailing addresses for certain eligible voters (that is, those who received the notice of the proposed suspension under section 432(e)(9)(F) in electronic form and those who regularly receive plan-related electronic communications from the plan sponsor). The plan sponsor must also furnish the individualized estimates provided to eligible voters as part of the earlier notices described in section 432(e)(9)(F) (or, if an individualized estimate is no longer accurate for an eligible voter, a corrected version of that estimate) so that an individualized estimate can be included with the ballot for each eligible voter. These final regulations add a requirement for the plan sponsor to provide plan information (such as participant identification codes used by the plan) to enable the Treasury Department to verify the identity of each eligible voter, in order to ensure the integrity of the voting process. These materials must be provided no later than seven days after the date the Treasury Department has approved an application for a suspension of benefits.

Section 432(e)(9)(H)(iii) requires a plan sponsor to provide a ballot. These final regulations adopt the interpretation set forth in the 2015 regulations that, under this statutory requirement, the plan sponsor is responsible for the costs of providing the ballot package to eligible voters, including the costs associated with printing, assembling, and mailing those ballot packages.

The final regulations provide that ballot packages will be distributed to eligible voters by first-class U.S. mail. A supplemental copy of the ballot package that includes the same content as the mailed ballot package may also be sent by an electronic communication to an eligible voter who has consented to receive electronic notifications. For example, if an eligible voter notifies the Treasury Department or the designated service provider that the mailed ballot package has not been received, then a supplemental copy of the ballot package may be provided by electronic mail.

The final regulations provide guidance regarding the plan sponsor's duty under section 432(e)(9)(H)(iv) to communicate with eligible voters. Under the final regulations, the plan sponsor must notify certain eligible voters (using an electronic communication) that the ballot package will be mailed to them by first-class U.S. mail. The eligible voters who must be notified under this rule are those who received the notice of the proposed suspension under section 432(e)(9)(F) in electronic form and those who regularly receive plan-related electronic communications from the plan sponsor.[12] This notification must be sent promptly after the plan sponsor is informed of the ballot distribution date. This notification in electronic form ensures that those eligible voters who ordinarily expect to receive communications from the plan sponsor in electronic form are aware that a ballot package will arrive via first-class U.S. mail. This notification must be sent by the plan sponsor, rather than the Treasury Department or a service provider, so that the communication comes from a familiar source, which will make it less likely that the communication is filtered from delivery as spam or junk mail.

As previously described in section VII of this preamble, a plan sponsor must make reasonable efforts to contact individuals whose initial suspension notices that were provided by mail were returned as undeliverable. The mailing addresses for the ballot packages that are furnished by the plan sponsor must reflect updates resulting from those reasonable efforts. If ballot packages sent to eligible voters are returned as undeliverable, the plan sponsor must make similar reasonable efforts to locate those eligible voters after being notified that their ballots were returned as undeliverable.

D. *Contents of ballot*

The final regulations provide that the ballot must be written in a manner that can be readily understood by the average plan participant and may not include any false or misleading information. The ballot must contain the following information:

- A description of the proposed suspension and its effect, including the effect of the suspension on each category or group of individuals affected by the suspension and the extent to which they are affected;
- A description of the factors considered by the plan sponsor in designing the benefit suspension, including but not limited to the factors in section 432(e)(9)(D)(vi);
- A description of whether the suspension will remain in effect indefinitely or will expire by its own terms (and, if it will expire by its own terms, when that will occur);
- A statement from the plan sponsor in support of the proposed suspension;
- A statement in opposition to the proposed suspension compiled from comments received pursuant to the solicitation of comments in the **Federal Register** notice with respect to the application;
- A statement that the proposed suspension has been approved by the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor;
- A statement that the plan sponsor has determined that the plan will become insolvent unless the proposed suspension takes effect (including the year in which insolvency is projected to occur without a suspension of benefits), and an accompanying statement that this determination is subject to uncertainty;
- A statement that insolvency of the plan could result in benefits lower than benefits paid under the proposed suspension and a description of the projected benefit payments in the event of plan insolvency;
- A statement that insolvency of PBGC would result in benefits lower than benefits otherwise paid in the case of plan insolvency;
- A statement that the plan's actuary has certified that the plan is projected to avoid insolvency, taking into account the proposed suspension of benefits (and, if applicable, a proposed partition of the plan), and an accompanying statement that the actuary's projection is subject to uncertainty;
- A statement that the suspension will go into effect unless a majority of eli-

[12]The plan sponsor is also permitted to send this notification to any other eligible voters for whom the plan sponsor has an electronic mailing address.

gible voters vote to reject the suspension and that, therefore, a failure to vote has the same effect on the outcome of the vote as a vote in favor of the suspension;
- A copy of the individualized estimate that was provided as part of the earlier notice described in section 432(e)(9)(F) (or, if that individualized estimate is no longer accurate, a corrected version of that estimate); and
- A description of the voting procedures, including the deadline for voting.

These final regulations provide that the statement in opposition to the proposed suspension that is compiled from comments received on the application will be prepared by the Labor Department. The final regulations provide that this statement in opposition must be written in a manner that is readily understandable to the average plan participant. If there are no comments in opposition to the proposed suspension, then the statement in opposition will indicate that there were no such comments.

Model language for use in the ballot may be published in the form of a revenue procedure, notice, or other guidance published in the Internal Revenue Bulletin.

### E. *Timing rules for the participant vote*

In accordance with section 432(e)(9)(H)(ii), the final regulations require that the Treasury Department (in consultation with PBGC and the Labor Department) administer the participant vote no later than 30 days following the date of approval of an application for a suspension of benefits. The final regulations interpret the term "administer a vote" to mean that eligible voters must have the opportunity to vote beginning no later than 30 days following approval of the application, but the regulations do not require voting to be completed within that 30-day time frame. Accordingly, ballot packages must be distributed no later than 30 days after the application has been approved, and the voting period (the period during which a vote received from an eligible voter will be counted) begins on the ballot distribution date. Although ballot packages may be distributed at any time up to 30 days following approval of an application for suspension of benefits, it is generally expected that ballot packages will be distributed well before that deadline.

The final regulations specify that the voting period generally will remain open until the 30th day following the date the Treasury Department approves the application for a suspension of benefits. However, the voting period will not close earlier than 21 days after the ballot distribution date. In addition, the Treasury Department (in consultation with PBGC and the Labor Department) is permitted to specify a later end to the voting period in appropriate circumstances. For example, an extension might be appropriate if, near the end of the original voting period, there are significant technical difficulties with respect to the collection of votes and those technical difficulties are not resolved in time to provide eligible voters with sufficient time to cast their votes.

### F. *Methods for casting votes*

The final regulations specify that an automated voting system must be made available to the eligible voters under which each eligible voter who furnishes a voter identification code must be able to cast a vote to be tabulated by the automated voting system. Such a system must be designed to record votes both electronically (through a website) and telephonically (through a toll-free number that allows votes to be cast using both a touch-tone voting system and an interactive voice response system). Because the system includes interactive voice response capability, eligible voters can cast votes on their home phones (including rotary phones) and all types of mobile phones (including phones that cannot access the internet). This type of system will permit any voter who lacks internet access or, for any reason, is unwilling or unable to vote via a website, to cast a vote using a toll-free number.

A number of commenters to the 2015 regulations requested that eligible voters be permitted to cast votes by mail. In response to these comments, the final regulations provide that, in appropriate circumstances, the Treasury Department may, in consultation with PBGC and the Labor Department, allow voters to cast votes by mail in lieu of using the automated voting system.[13] If voters are permitted to cast votes by mail then the ballot package must include a postage prepaid, return addressed envelope for use in returning the completed ballot.

### G. *General procedures following the vote*

Under section 432(e)(9)(H)(ii), a proposed suspension is generally permitted to be implemented unless rejected by a majority vote of all eligible voters. Numerous commenters expressed dissatisfaction with this statutory provision, and several commenters suggested that the regulations require a majority of eligible voters to vote in favor of a suspension before it is permitted to take effect. The Treasury Department and the IRS have not adopted this suggestion because it is inconsistent with the statutory language.

As under the 2015 regulations, the final regulations provide that, for purposes of determining whether a majority of all eligible voters have voted to reject the suspension under section 432(e)(9)(H)(ii), any eligible voters to whom ballots have not been provided (because the individuals could not be located) are treated as voting to reject the suspension at the same rate (in other words, in the same percentage) as those to whom ballots have been provided.

In accordance with section 432(e)(9)(H)(ii), the final regulations require that an approved suspension will be permitted to take effect unless a majority of all eligible voters vote to reject the suspension. If a majority of all eligible voters vote to reject the suspension, the suspension will not be permitted to take effect (except that, as described in section IX.H of this preamble, the suspension or a modified suspension will be permitted to go into effect if the plan is a systemically important plan). A plan sponsor is permitted to submit a new suspension application to the Treasury Department for approval in any case in which a suspension

[13] If a mail-in ballot is permitted then it must be received before the end of the voting period in order to be considered.

is prohibited from taking effect as a result of a vote.

### H. *Special rules for systemically important plans*

The final regulations set forth rules for systemically important plans that are generally the same as the rules set forth in the 2015 regulations. The final regulations provide that if a majority of all eligible voters vote to reject the suspension, the Treasury Department will consult with PBGC and the Labor Department to determine if the plan is a systemically important plan. The Treasury Department is required to make this determination no later than 14 days after the results of the vote are certified.

The final regulations provide that the Participant and Plan Sponsor Advocate selected under section 4004 of ERISA may, in the case of a systemically important plan, submit recommendations to the Treasury Department with respect to an approved suspension (or any modifications to an approved suspension). Under the 2015 regulations, the Participant and Plan Sponsor Advocate was given up to 30 days after the Treasury Department's determination that the plan is systemically important to make this recommendation. The final regulations change this deadline to give the Participant and Plan Sponsor Advocate up to 44 days after the results of the participant vote are certified to submit any recommendations. This 44-day period provides the Participant and Plan Sponsor Advocate with 30 days following the Treasury Department's determination to make its recommendations if the Treasury Department uses the entire 14 days to determine that plan is a systemically important plan (and provides the Participant and Plan Sponsor Advocate a longer time if the Treasury Department makes its determination at an earlier date).

As under the 2015 regulations, the final regulations provide that if a plan is a systemically important plan for which a majority of all eligible voters vote to reject the suspension then, as required under section 432(e)(9)(H)(v), the Treasury Department will either permit the implementation of the suspension that was rejected by the vote or permit the implementation of a modification of that suspension. Under any such modification, the plan must be projected to avoid insolvency in accordance with section 432(e)(9)(D)(iv). No later than 60 days after the results of a vote to reject a suspension are certified, the Treasury Department will notify the plan sponsor that the suspension (or a modified suspension) is permitted to be implemented.

The final regulations adopt the definition of a systemically important plan from the 2015 regulations, with a minor clarification. Under the final regulations, a systemically important plan is a plan with respect to which PBGC projects that the present value of its financial assistance payments will exceed $1.0 billion if the suspension is not implemented. The final regulations clarify that this $1.0 billion threshold is indexed for inflation.

### I. *Final Treasury Department authorization or notification following the vote*

As under the 2015 regulations, the final regulations provide that in any case in which a proposed suspension (or a modification of a proposed suspension) is permitted to go into effect, the Treasury Department, in consultation with PBGC and the Labor Department, will issue a final authorization to suspend with respect to the suspension. If a suspension is permitted to go into effect following a vote, the final authorization will be issued no later than seven days after the vote. If a suspension is permitted to go into effect following a determination that the plan is a systemically important plan, the final authorization will be issued at a time sufficient to allow the implementation of the suspension prior to the end of the 90-day period beginning on the date the results of the vote rejecting the suspension are certified. Under the final regulations, no later than 60 days after the certification, the Treasury Department will notify the plan sponsor that the suspension that was rejected by the vote or a modified suspension is permitted to be implemented.

## Effective/Applicability Dates

These regulations are effective on April 28, 2016. The final regulations under § 1.432(e)(9)–1 apply with respect to suspensions for which the approval or denial is issued on or after April 26, 2016. In the case of a systemically important plan, the final regulations apply with respect to any modified suspension implemented on or after that date.

## Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov*.

## Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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.

The Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6) requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities. In this case, the IRS and Treasury believe that the regulations likely would not have a ''significant economic impact on a substantial number of small entities.'' 5 U.S.C. 605. This certification is based on the fact that the number of small entities affected by this rule is unlikely to be substantial because it is unlikely that a substantial number of small multiemployer plans in critical and declining status will suspend benefits under section 432(e)(9).

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Contact Information

For general questions regarding these regulations, please contact the Department of the Treasury MPRA guidance information line at (202) 622-1559 (not a toll-free number). For information regarding a specific application for a suspension of benefits, please contact the Department of the Treasury at (202) 622-1534 (not a toll-free number).

* * * * *

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR parts 1 is amended as follows:

**PART 1—INCOME TAXES**

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

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

Par. 2. Section 1.432(e)(9)–1 is added to read as follows:

*§ 1.432(e)(9)–1 Benefit suspensions for multiemployer plans in critical and declining status.*

(a) *General rules on suspension of benefits*—(1) *General rule*. Subject to section 432(e)(9)(B) through (I) and this section, the plan sponsor of a multiemployer plan that is in critical and declining status (within the meaning of section 432(b)(6)) for a plan year may, by plan amendment adopted in the plan year, implement a suspension of benefits that the plan sponsor deems appropriate. Such an amendment is permitted notwithstanding the anti-cutback provisions of section 411(d)(6). As amended, the terms of the plan must satisfy the requirements of section 401(a).

(2) *Adoption of plan terms inconsistent with suspension requirements*—(i) *General rule*. A plan may implement (or continue to implement) a reduction of benefits pursuant to a suspension of benefits only if the terms of the plan are consistent with the requirements of section 432(e)(9) and this section.

(ii) *Changes in level of suspension*—(A) *Phased-in suspension*. A plan's terms are consistent with the requirements of section 432(e)(9) even if the plan provides that, instead of a suspension of benefits occurring in full on a specified effective date, the amount of a suspension will phase in or otherwise change in a definite, pre-determined manner as of a specified future effective date or dates.

(B) *Level of suspension contingent on future events*. Except as otherwise provided in this paragraph (a)(2)(ii), a plan's terms are inconsistent with the requirements of section 432(e)(9) if they provide that the amount of a suspension will change contingent upon the occurrence of any other specified future event, condition, or development. For example, a plan is not permitted to provide that an additional or larger suspension of benefits is triggered if the plan's funded status deteriorates. Similarly, a plan is not permitted to provide that a suspension of benefits is decreased if the plan's funded status improves (except upon a failure to satisfy the annual plan sponsor determinations requirement of paragraph (c)(4) of this section).

(C) *Level of suspension contingent on future status of individual*. A plan's terms are not inconsistent with the requirements of section 432(e)(9) merely because they provide that, for a participant who has not commenced benefits before the effective date of the suspension, the amount of the suspension will change upon the occurrence of a specified future event, condition or development (such as retirement, death, or disability) with respect to the participant.

(3) *Organization of the regulation*. This paragraph (a) contains definitions and general rules relating to a suspension of benefits by a multiemployer plan under section 432(e)(9). Paragraph (b) of this section defines a suspension of benefits and describes the length of a suspension, the treatment of beneficiaries and alternate payees under this section, and the requirement to select a retiree representative. Paragraph (c) of this section prescribes certain rules for the actuarial certification and plan sponsor determinations that must be made in order for a plan to suspend benefits. Paragraph (d) of this section describes certain limitations on suspensions of benefits. Paragraph (e) of this section prescribes rules relating to benefit improvements.. Paragraph (f) of this section describes the requirement to provide notice in connection with an application to suspend benefits. Paragraph (g) of this section describes certain requirements with respect to the approval or denial of an application for a suspension of benefits. Paragraph (h) of this section contains certain rules relating to the vote on an approved suspension, systemically important plans, and the issuance of a final authorization to suspend benefits. Paragraph (j) of this section provides the effective/applicability date of this section.

(4) *Definitions*. The following definitions apply for purposes of this section—

(i) *Pay status*. A person is in pay status under a multiemployer plan if, as described in section 432(j)(6), at any time during the current plan year, the person is a participant, beneficiary, or alternate payee under the plan and is paid an early, late, normal, or disability retirement benefit under the plan (or a death benefit under the plan related to a retirement benefit).

(ii) *Plan sponsor*. The term plan sponsor means the association, committee, joint board of trustees, or other similar group of representatives of the parties that establishes or maintains the multiemployer plan. However, in the case of a plan described in section 404(c), or a continuation of such a plan, the term plan sponsor means the association of employers that is the employer settlor of the plan.

(iii) *Effective date of suspension of benefits*—(A) *Individuals who are receiving benefits*. In the case of a suspension affecting an individual who is receiving benefits when the suspension is implemented, the effective date of a suspension of benefits is the first date as of which any portion of the individual's benefits are not paid as a result of the suspension.

(B) *Individuals who are not receiving benefits*. In the case of a suspension affecting individuals other than individuals described in paragraph (a)(4)(iii)(A) of this section, the effective date of the suspension is the first date as of which the individual's entitlement to benefits is reduced as a result of the implementation of the suspension, regardless of whether the individual is eligible to commence benefits at that date.

(C) *Phased-in suspension*. If a suspension of benefits provides for more than one reduction in benefits over time, such that benefits are scheduled to be reduced by an additional amount after benefits are first reduced pursuant to the suspension, then each date as of which benefits are reduced is treated as a separate effective date of the suspension. However, if the effective date of the final scheduled reduction in benefits in a series of reductions pursuant to a suspension is less than three years later than the effective date of the first reduction, then the effective date of the first reduction will be treated as the effective date of all subsequent reductions pursuant to that suspension.

(D) *Effective date may not be retroactive*. The effective date of a suspension may not precede the date on which a final authorization to suspend benefits is issued pursuant to paragraph (h)(6) of this section.

(b) *Definition of suspension of benefits and related rules*—(1) *In general*—(i) *Definition*. For purposes of this section, the term suspension of benefits means the temporary or permanent reduction, pursuant to the terms of the plan, of any current or future payment obligation of the plan with respect to any plan participant. A suspension of benefits may apply with respect to a plan participant regardless of whether the participant, beneficiary, or alternate payee commenced receiving benefits before the effective date of the suspension of benefits.

(ii) *Plan not liable for suspended benefits*. If a plan pays a reduced level of benefits pursuant to a suspension of benefits that complies with the requirements of section 432(e)(9) and this section, then the plan is not liable for any benefits not paid as a result of the suspension.

(2) *Length of suspension*—(i) *In general*. A suspension of benefits may be of indefinite duration or may expire as of a date that is specified in the plan amendment implementing the suspension.

(ii) *Effect of a benefit improvement*. A plan sponsor may amend the plan to eliminate some or all of a suspension of benefits, provided that the amendment satisfies the requirements that apply to a benefit improvement under section 432(e)(9)(E), in accordance with the rules of paragraph (e) of this section.

(3) *Treatment of beneficiaries and alternate payees*. Except as otherwise specified in this section, all references to suspensions of benefits, increases in benefits, or resumptions of suspended benefits with respect to participants also apply with respect to benefits of beneficiaries or alternate payees (as defined in section 414(p)(8)) of participants.

(4) *Retiree representative*—(i) *In general*—(A) *Requirement to select retiree representative*. The plan sponsor of a plan that intends to submit an application for a suspension of benefits and that has reported a total of 10,000 or more participants as of the end of the plan year for the most recently filed Form 5500, Annual Return/Report of Employee Benefit Plan, must select a retiree representative. The plan sponsor must select the retiree representative at least 60 days before the date the plan sponsor submits an application to suspend benefits. The retiree representative must be a plan participant who is in pay status. The retiree representative may or may not be a plan trustee.

(B) *Role of retiree representative*. The role of the retiree representative is to advocate for the interests of the retired and deferred vested participants and beneficiaries of the plan, beginning when the retiree representative is selected and continuing throughout the suspension approval process. In the discretion of the plan sponsor, the retiree representative may continue in this role throughout the period of the benefit suspension.

(ii) *Reasonable expenses from plan*. The plan must pay reasonable expenses incurred by the retiree representative, including reasonable expenses for legal and actuarial support and communication with retired and deferred vested participants and beneficiaries, commensurate with the plan's size and funded status.

(iii) *Disclosure of information*. Upon request, the plan sponsor must promptly provide the retiree representative with relevant information, such as plan documents and data, that is reasonably necessary to enable the retiree representative to perform the role described in paragraph (b)(4)(i)(B) of this section.

(iv) *Special rules relating to fiduciary status*. See section 432(e)(9)(B)(v)(III) for rules relating to the fiduciary status of a retiree representative.

(v) *Retiree representative for other plans*. The plan sponsor of a plan that has reported fewer than 10,000 participants as of the end of the plan year for the most recently filed Form 5500, Annual Return/ Report of Employee Benefit Plan is permitted to select a retiree representative. The rules in this paragraph (b)(4) (other than the rules in the first two sentences of paragraph (b)(4)(i)(A) of this section concerning the size of the plan and the timing of the appointment of the retiree representative) apply to such a representative.

(c) *Conditions for suspension*—(1) *In general*—(i) *Actuarial certification and initial plan sponsor determinations*. The plan sponsor of a plan in critical and declining status for a plan year may suspend benefits only if the actuarial certification requirement in paragraph (c)(2) of this section and the initial plan sponsor determinations requirement in paragraph (c)(3) of this section are met.

(ii) *Annual requirement to make plan sponsor determinations*. As provided in paragraph (c)(5) of this section, the suspension will continue only if the plan sponsor continues to make the annual plan sponsor determinations described in paragraph (c)(4) of this section.

(2) *Actuarial certification*. A plan satisfies the actuarial certification requirement of this paragraph (c)(2) if, taking into account the proposed suspension of benefits (and, if applicable, a proposed partition of the plan under section 4233 of the Employee Retirement Income Security Act of 1974, Public Law 93–406 (88 Stat. 829 (1974)), as amended (ERISA)), the plan's actuary certifies that the plan is projected to avoid insolvency within the meaning of section 418E, assuming the suspension of benefits continues until it expires by its own terms or if no such expiration date is set, indefinitely.

(3) *Initial plan sponsor determinations*—(i) *General rule*. A plan satisfies the initial plan sponsor determinations requirement of this paragraph (c)(3) only if the plan sponsor determines that—

(A) All reasonable measures to avoid insolvency, within the meaning of section 418E, have been taken; and

(B) The plan would not be projected to avoid insolvency (determined using the standards described in paragraphs (d)(5)(ii), (iv), and (v) of this section) if no suspension of benefits were applied under the plan.

(ii) *Factors*. In making its determination that all reasonable measures to avoid insolvency, within the meaning of section 418E, have been taken, the plan sponsor may take into account the following nonexclusive list of factors—

(A) Current and past contribution levels;

(B) Levels of benefit accruals (including any prior reductions in the rate of benefit accruals);

(C) Prior reductions (if any) of adjustable benefits;

(D) Prior suspensions (if any) of benefits under this section;

(E) The impact on plan solvency of the subsidies and ancillary benefits available to active participants;

(F) Compensation levels of active participants relative to employees in the participants' industry generally;

(G) Competitive and other economic factors facing contributing employers;

(H) The impact of benefit and contribution levels on retaining active participants and bargaining groups under the plan;

(I) The impact of past and anticipated contribution increases under the plan on employer attrition and retention levels; and

(J) Measures undertaken by the plan sponsor to retain or attract contributing employers.

(iii) *Reliance on certification of critical and declining status*. For purposes of the insolvency projection under paragraph (c)(3)(i)(B) of this section, a plan sponsor may rely on the actuarial certification made pursuant to section 432(b)(3)(A)(i) that the plan is in critical and declining status for the plan year in making the determination that the plan is projected to become insolvent unless benefits are suspended.

(4) *Annual plan sponsor determinations*—(i) *General rule*. A plan satisfies the annual plan sponsor determinations requirement of this paragraph (c)(4) for a plan year only if the plan sponsor determines, no later than the last day of the plan year, that—

(A) All reasonable measures to avoid insolvency have been and continue to be taken; and

(B) The plan would not be projected to avoid insolvency (determined using the standards described in paragraphs (d)(5)(ii), (iv), and (v) of this section, substituting the current plan year for the plan year that includes the effective date of the suspension) if no suspension of benefits were applied under the plan.

(ii) *Factors*. In making its determination that all reasonable measures to avoid insolvency have been and continue to be taken, the plan sponsor may take into account the non-exclusive list of factors in paragraph (c)(3)(ii) of this section.

(iii) *Requirement to maintain written record*. The plan sponsor must maintain a written record of the annual plan sponsor determinations made under this paragraph (c)(4). The written record must be included in an update to the rehabilitation plan, whether or not there is otherwise an update for that year (or, if the plan is no longer in critical status, must be included in the documents under which the plain is maintained). The written record of the determinations must describe the plan sponsor's consideration of factors, as described in paragraph (c)(4)(ii) of this section.

(5) *Failure to make annual plan sponsor determinations*. If a plan sponsor fails to satisfy the annual plan sponsor determinations requirement of paragraph (c)(4) of this section for a plan year (including maintaining the written record described in paragraph (c)(4)(iii) of this section), then the suspension of benefits will cease to be in effect beginning as of the first day of the next plan year.

(d) *Limitations on suspension*—(1) *In general*. Any suspension of benefits with respect to a participant made by a plan sponsor pursuant to this section is subject to the individual limitations of sections 432(e)(9)(D)(i) through (iii) and paragraphs (d)(2) through (d)(4) of this section. After applying those provisions, the overall size and distribution of the suspension is subject to the aggregate limitations of sections 432(e)(9)(D)(iv) and (vi) and paragraphs (d)(5) and (d)(6) of this section. See section 432(e)(9)(D)(vii) and paragraph (d)(8) of this section for additional rules applicable to certain plans.

(2) *Guarantee-based limitation*—(i) *General rule*. The reduction with respect to a participant under a suspension of benefits must be limited so that, on and after the effective date of the suspension, the monthly benefit is not less than the guarantee-based limitation. The guarantee-based limitation is 110 percent of the monthly benefit payable to a participant, beneficiary, or alternate payee that would be guaranteed by the Pension Benefit Guaranty Corporation (PBGC) under section 4022A of ERISA if the plan were to become insolvent as of the effective date of the suspension.

(ii) *PBGC guarantee*. Under section 4022A of ERISA, the monthly benefit of a participant or beneficiary that would be guaranteed by PBGC with respect to a plan if the plan were to become insolvent as of the effective date of the suspension is generally based on section 4022A(c)(1) of ERISA. Under that section, the monthly benefit that would be guaranteed if the plan were to become insolvent as of the date as of which the guarantee is determined is the product of—

(A) 100 percent of the accrual rate up to $11, plus 75 percent of the lesser of—

(*1*) $33; or

(*2*) The accrual rate, if any, in excess of $11; and

(B) The number of the participant's years and months of credited service as of that date.

(iii) *Calculation of accrual rate*. The accrual rate, as defined in section 4022A(c)(2) of ERISA, is calculated by dividing—

(A) The participant's or beneficiary's monthly benefit, described in section 4022A(c)(2)(A) of ERISA; by

(B) The participant's years of credited service, described in section 4022A(c)(3) of ERISA, as of the effective date of the suspension.

(iv) *Special rule for non-vested participants*. For purposes of this paragraph (d)(2), a participant's nonforfeitable benefits under section 4022A(a) of ERISA include benefits that are forfeitable as of the effective date of the suspension, provided that the participant would have a nonforfeitable right to those benefits if the participant continued to earn vesting service following that date.

(v) *Examples*. The following examples illustrate the limitation on a suspension of benefits under this paragraph (d)(2). Unless otherwise stated, the amount of guarantee payable by PBGC in these examples is based on section 4022A(c) of ERISA, and the rules under section 4022A(d) of ERISA (guarantee for benefits reduced under section 411(a)(3)(E)), section 4022A(e) of ERISA (benefits ineligible for guarantee), and section 4022A(h) of ERISA (guarantee for benefits accrued as of July 30, 1980) do not apply. In these examples, unless otherwise stated, the monthly benefits are nonforfeitable, are based on benefits that have been in effect for at least 60 months as of the effective date of the suspension, and are no greater than the monthly benefit that would be payable at normal retirement age in the form of a single life annuity.

*Example 1*. (i) *Facts*. A participant is receiving a benefit of $1,500 per month immediately prior to the effective date of the suspension. The participant has 30 years of credited service under the plan.

(ii) *Calculation of accrual rate*. The participant's accrual rate is $50, calculated by dividing the participant's monthly benefit payment ($1,500) by the participant's years of credited service (30).

(iii) *Calculation of monthly PBGC-guaranteed benefit*. The first $11 of the accrual rate is fully guaranteed, and the next $33 of the accrual rate is 75% guaranteed ($33 x .75 = $24.75). The participant's monthly guaranteed benefit per year of credited service is $35.75 ($11 + $24.75 = $35.75). The PBGC guarantee formula is then applied to produce the amount of guarantee payable by PBGC, which is $1,072.50 ($35.75 x 30 years = $1,072.50).

(iv) *Calculation of guarantee-based limitation*. A suspension of benefits may not reduce the participant's benefits, determined on and after the effective date of the suspension, below the guarantee-based limitation, which is equal to 110% of the amount of guarantee payable by PBGC. That monthly amount is $1,179.75 ($1,072.50 x 1.1 = $1,179.75).

*Example 2*. (i) *Facts*. The facts are the same as in *Example 1*, except that the participant is deceased and, immediately prior to the effective date of the suspension, the participant's beneficiary is receiving a monthly benefit of $750 under a 50% joint and survivor annuity.

(ii) *Calculation of accrual rate*. The beneficiary's accrual rate is $25, calculated by dividing the beneficiary's monthly benefit payment ($750) by the participant's years of credited service (30).

(iii) *Calculation of monthly PBGC-guaranteed benefit*. The first $11 of the accrual rate is fully guaranteed, and the next $14 ($25 – $11 = $14) of the accrual rate is 75% guaranteed ($14 x .75 = $10.50). The beneficiary's monthly guaranteed benefit is $21.50 per year of credited service ($11 + $10.50 = $21.50). The PBGC guarantee formula is then applied to produce the amount of guarantee payable by PBGC, which is $645 ($21.50 x 30 years = $645).

(iv) *Calculation of guarantee-based limitation*. A suspension of benefits may not reduce the beneficiary's benefits, determined on and after the effective date of the suspension, below the guarantee-based limitation, which is equal to 110% of the monthly amount of guarantee payable by PBGC. That monthly guarantee-based limitation amount is $709.50 ($645 x 1.1 = $709.50).

*Example 3*. (i) *Facts*. A participant would be eligible for a monthly benefit of $1,000 payable as a single life annuity at normal retirement age, based on the participant's 25 years of credited service. The plan also permits a participant to receive a benefit on an unreduced basis as a single life annuity at a particular early retirement age and permits participants to receive an early retirement benefit beginning at that age in the form of a social security level income option. The participant has elected the social security level income option under which the participant receives a monthly benefit of $1,600 prior to normal retirement age (which is the plan's assumed social security retirement age) and $900 after normal retirement age.

(ii) *Calculation of accrual rate*. For purposes of calculating the accrual rate, the monthly benefit that is used to calculate the PBGC guarantee does not exceed the monthly benefit of $1,000 that would be payable at normal retirement age. In calculating the accrual rate, the amount of guarantee payable by PBGC would be based on a monthly benefit of $1,000 prior to normal retirement age and $900 after normal retirement age. Before normal retirement age, the participant's accrual rate is $40, determined by dividing the participant's monthly benefit payment ($1,000) by years of credited service (25). After normal retirement age, the participant's accrual rate is $36, calculated by dividing the participant's monthly benefit payment ($900) by the participant's years of credited service (25).

(iii) *Calculation of monthly PBGC-guaranteed benefit*. Before normal retirement age, the first $11 of the accrual rate is fully guaranteed, and the next $29 of the accrual rate is 75% guaranteed ($29 x .75 = $21.75). The participant's monthly guaranteed benefit per year of credited service is $32.75 ($11 + $21.75 = $32.75). The PBGC guarantee formula is then applied to produce the amount of guarantee payable by PBGC, which is $818.75 ($32.75 x 25 years = $818.75). After normal retirement age, the first $11 of the accrual rate is fully guaranteed, and the next $25 of the accrual rate is 75% guaranteed ($25 x .75 = $18.75). The participant's monthly guaranteed benefit per year of credited service is $29.75 ($11 + $18.75 = $29.75). The PBGC guarantee formula is then applied to produce the amount of guarantee payable by PBGC, which is $743.75 after normal retirement age ($29.75 x 25 years = $743.75).

(iv) *Calculation of guarantee-based limitation*. A suspension of benefits may not reduce the participant's benefits, determined on and after the effective date of the suspension, below the guarantee-based limitation, which is equal to 110% of the monthly amount of guarantee payable by PBGC. That monthly guarantee-based limitation amount is $900.63 ($818.75 x 1.1 = $900.63) before normal retirement age and $818.13 ($743.75 x 1.1 = $818.13) after normal retirement age.

*Example 4*. (i) *Facts.* A participant would be eligible for a monthly benefit of $1,000 payable as a single life annuity at normal retirement age, based on the participant's 20 years of credited service. The plan provides an actuarial increase for delaying benefits until after normal retirement age. The participant delays commencement of benefits until after normal retirement age and the monthly benefit the participant is receiving immediately before the effective date of the suspension is $1,200 instead of $1,000.

(ii) *Calculation of accrual rate*. For purposes of calculating the accrual rate, the monthly benefit that is used to calculate the PBGC guarantee does not exceed the monthly benefit of $1,000 that would be payable at normal retirement age. Thus, in determining the accrual rate, the PBGC guarantee would be based on a monthly benefit of $1,000, whether benefits are paid at or after normal retirement age. The participant's accrual rate is $50, calculated by dividing the participant's monthly benefit payment ($1,000) by the participant's years of credited service (20).

(iii) *Calculation of monthly PBGC-guaranteed benefit*. The first $11 of the accrual rate is fully guaranteed, and the next $33 of the accrual rate is 75% guaranteed ($33 x .75 = $24.75). The participant's monthly guaranteed benefit per year of credited service is $35.75 ($11 + $24.75 = $35.75). The PBGC guarantee formula is then applied to produce the amount of guarantee payable by PBGC, which is $715 ($35.75 x 20 years = $715).

(iv) *Calculation of guarantee-based limitation*. A suspension of benefits may not reduce the participant's benefits, determined on and after the effective date of the suspension, below the guarantee-based limitation, which is equal to 110% of the monthly amount of guarantee payable by PBGC. That monthly guarantee-based limitation amount is $786.50 ($715 x 1.1 = $786.50).

*Example 5*. (i) *Facts.* A plan provides that a participant who has completed at least five years of service will have a nonforfeitable right to 100% of an accrued benefit (and will not have a nonforfeitable right to any portion of the accrued benefit prior to completing five years of service). The plan implements a suspension of benefits on January 1, 2017. As of that date, a participant has three years of vesting service, and none of the participant's benefits are nonforfeitable under the terms of the plan.

(ii) *Calculation of nonforfeitable benefits*. For purposes of applying the guarantee-based limitation, the participant is considered to have a nonforfeitable right to 100% of the accrued benefit under the plan as of January 1, 2017.

(3) *Age-based limitation*—(i) *No suspension for participants or beneficiaries who are age 80 and older*. Pursuant to the age-based limitation of this paragraph (d)(3), no suspension of benefits is permitted to apply to a participant or beneficiary who—

(A) Has commenced benefits as of the effective date of the suspension; and

(B) Has attained 80 years of age no later than the end of the month that includes the effective date of the suspension.

(ii) *Limited suspension for participants and beneficiaries between ages 75 and 80*. Pursuant to the age-based limitation of this paragraph (d)(3), no more than the applicable percentage of the maximum suspendable benefit may be suspended for a participant or beneficiary who—

(A) Has commenced benefits as of the effective date of the suspension; and

(B) Has attained 75 years of age no later than the end of the month that includes the effective date of the suspension.

(iii) *Maximum suspendable benefit*—(A) *In general*. For purposes of this paragraph (d)(3), the maximum suspendable benefit with respect to a participant, beneficiary, or alternate payee is the portion of the individual's benefits that would otherwise be suspended pursuant to this section (that is, the amount that would be suspended without regard to the limitation of this paragraph (d)(3)).

(B) *Coordination of limitations*. An individual's maximum suspendable benefit is calculated after the application of the guarantee-based limitation under paragraph (d)(2) of this section and the disability-based limitation under paragraph (d)(4) of this section.

(iv) *Applicable percentage*. For purposes of this paragraph (d)(3), the applicable percentage is the percentage obtained by dividing—

(A) The number of months during the period beginning with the month after the month in which the suspension of benefits is effective and ending with the month during which the participant or beneficiary attains the age of 80, by

(B) 60.

(v) *Applicability of age-based limitation to benefits paid to beneficiaries*. If the age-based limitation of this paragraph (d)(3) applies to a participant on the effective date of the suspension, then the age-based limitation also applies to the beneficiary of the participant, based on the age of the participant as of the end of the month that includes the effective date of the suspension.

(vi) *Rule for benefits that have not commenced at the time of the suspension*. If benefits have not commenced to either a participant or beneficiary as of the effective date of the suspension, then in applying this paragraph (d)(3)—

(A) If the participant is alive on the effective date of the suspension, the participant is treated as having commenced benefits on that date; and

(B) If the participant dies before the effective date of the suspension, the beneficiary is treated as having commenced benefits on that date.

(vii) *Rules for alternate payees*. The age-based limitation of this paragraph (d)(3) applies to a suspension of benefits in which an alternate payee has an interest, whether or not the alternate payee has commenced benefits as of the effective date of the suspension. For purposes of this paragraph (d)(3), the applicable percentage for an alternate payee is calculated by—

(A) Using the participant's age as of the end of the month that includes the effective date of the suspension, if the alternate payee's right to the suspended benefits derives from a qualified domestic relations order within the meaning of section 414(p)(1)(A) (QDRO) under which the alternate payee shares in each benefit payment but the participant retains the right to choose the time and form of payment with respect to the benefit to which the suspension applies (shared payment QDRO); or

(B) Substituting the alternate payee's age as of the end of the month that includes the effective date of the suspension for the participant's age, if the alternate payee's right to the suspended benefits derives from a QDRO under which the alternate payee has a separate right to receive a portion of the participant's retirement benefit to be paid at a time and in a form different from that chosen by the participant (separate interest QDRO).

(viii) *Examples*. The following examples illustrate the rules of this paragraph (d)(3):

*Example 1*. (i) *Facts*. The plan sponsor of a plan in critical and declining status is implementing a suspension of benefits, effective December 1, 2017, that generally would reduce all benefit payments under the plan by 30%. On that date, a retiree is receiving a monthly benefit of $1,500 (which is not a benefit based on disability) and has 28 years of credited service under the plan. If none of the limitations in section 432(e)(9)(D)(i), (ii), and (iii) were to apply, a 30% suspension would reduce the retiree's monthly benefit by $450, to $1,050. Under the guarantee-based limitation in section 432(e)(9)(D)(i), the retiree's monthly benefit could not be reduced by more than $398.90, to $1,101.10 (1.1 x (28 x ($11 + (.75 x $33)))). The retiree is 77 years old on the effective date of the suspension, turns 78 on December 10, 2017, and turns 80 on December 10, 2019.

(ii) *Maximum suspendable benefit*. Because the retiree is not receiving a benefit based on disability under section 432(e)(9)(D)(iii), the retiree's maximum suspendable benefit is $398.90 (which is equal to the lesser of the amount of reduction that would apply pursuant to the 30% suspension ($450) or the amount of reduction that would be permitted under the guarantee-based limitation ($398.90)).

(iii) *Applicable percentage*. Because the retiree is between ages 75 and 80 on the effective date of the suspension, the reduction is not permitted to exceed the applicable percentage of the retiree's maximum suspendable benefit. The number of months during the period beginning with January 2018 (the month after the month that includes the effective date of the suspension) and ending with December 2019 (the month in which the retiree turns 80) is 24. The applicable percentage is equal to 40% (24 months divided by 60).

(iv) *Age-based limitation*. The retiree's maximum suspendable benefit is $398.90 and the applicable percentage is 40%. Thus, under the age-based limitation, the retiree's benefit may not be reduced by more than $159.56 ($398.90 x .40 = $159.56). Because the retiree was receiving a monthly benefit of $1,500, the suspension of benefits may not reduce the retiree's monthly benefit below $1,340.44 ($1,500 – $159.56 = $1,340.44).

*Example 2*. (i) *Facts*. The facts are the same as *Example 1*, except that the retiree is 79 years old on December 1, 2017, and turns 80 on December 20, 2017.

(ii) *Age-based limitation*. The suspension is not permitted to apply to the retiree because the retiree will turn 80 by the end of the month (December 2017) in which the suspension is effective.

*Example 3*. (i) *Facts*. The facts are the same as *Example 1*, but on the effective date of the suspension, the retiree is receiving a benefit in the form of a 50% joint and survivor annuity for himself and a contingent beneficiary who is age 71. The retiree dies in October 2018.

(ii) *Application of age-based limitation to contingent beneficiary*. Because the retiree had attained age 78 in the month that included the effective date of the suspension, the age-based limitation on the suspension of benefits for a 78-year-old individual applies to the retiree. The age-based limitation also applies to the contingent beneficiary, even though the contingent beneficiary had not commenced benefits under the plan as of the effective date of the suspension and had not attained age 75 by the end of the month containing the effective date of the suspension.

(iii) *Maximum suspendable benefit*. The contingent beneficiary's amount of guarantee payable by PBGC is based on the benefit the beneficiary would have received from the plan before the suspension ($750). The beneficiary's accrual rate is $26.7857 (calculated by dividing the monthly benefit payment ($750) by years of credited service (28)) and the beneficiary's amount of guarantee payable by PBGC is $639.50 (28 x ($11 + (.75 x $15.7857))). The beneficiary's maximum suspendable benefit is $46.55 (which is equal to the lesser of the amount of reduction that would apply pursuant to the 30% suspension ($225) or the amount of reduction that would be permitted under the guarantee-based limitation ($46.55, which is equal to ($750 – 1.1 x $639.50)).

(iv) *Applicable percentage*. The applicable percentage for the beneficiary is based on the retiree's age of 78 as of the end of the month that includes the effective date of the suspension. Accordingly, the applicable percentage for the beneficiary is 40%.

(v) *Age-based limitation*. The beneficiary's maximum suspendable benefit is $46.55 and the applicable percentage is 40%. Thus, under the age-based limitation, the beneficiary's benefit may not be reduced by more than $18.62 ($46.55 x .40 = $18.62). Therefore, as a result of the retiree's age-based limitation, the suspension of benefits may not reduce the beneficiary's monthly benefit below $731.38 ($750 – $18.62 = $731.38).

*Example 4*. (i) *Facts*. The facts are the same as *Example 3*, except that on the effective date of the suspension the retiree is age 71 and the retiree's contingent beneficiary is age 77.

(ii) *Application of age-based limitation to contingent beneficiary*. Because the retiree had not reached age 75 as of the end of the month that includes the effective date of the suspension, the age-based limitation on the suspension of benefits does not apply to the retiree. The age-based limitation also does not apply to the retiree's contingent beneficiary, even though the contingent beneficiary had attained age 77 as of the end of the month that includes the effective date of the suspension, because the contingent beneficiary had not yet commenced benefits on that date. The beneficiary's post-suspension benefit may not be less than the minimum benefit payable pursuant to the guarantee-based limitation, which is $703.45 ($639.50 x 1.1 = $703.45).

*Example 5*. (i) *Facts*. The facts are the same as in *Example 4*, except that the retiree died in October 2017, prior to the December 1, 2017 effective date of the suspension of benefits. The retiree's beneficiary commenced benefits on November 1, 2017.

(ii) *Application of age-based limitation to contingent beneficiary*. Because the retiree's beneficiary had commenced benefits before the effective date of the suspension and had reached age 75 as of the end of the month that includes the effective date of the suspension, the age-based limitation applies to the beneficiary based on the beneficiary's age as of the end of the month that includes the effective date of the suspension.

(4) *Disability-based limitation*—(i) *General rule*. Pursuant to the disability-based limitation of this paragraph (d)(4), benefits based on disability (as defined under the plan) may not be suspended.

(ii) *Benefits based on disability*—(A) *In general*. For purposes of this section, benefits based on disability means the entire amount paid to a participant pursuant to the participant becoming disabled, without regard to whether a portion of that amount would have been paid if the participant had not become disabled.

(B) *Rule for auxiliary or other temporary disability benefits*. If a participant begins receiving an auxiliary or other temporary disability benefit and the sole reason the participant ceases receiving that benefit is commencement of retirement benefits, then the benefit based on disability after commencement of retirement benefits is the lesser of—

(*1*) The periodic payment the participant was receiving immediately before the participant's retirement benefits commenced; or

(*2*) The periodic payment to the participant of retirement benefits under the plan.

(C) *Examples*. The following examples illustrate the disability-based limitation on a suspension of benefits under this paragraph (d)(4):

*Example 1*. (i) *Facts*. A participant with a vested accrued benefit of $1,000 per month, payable at age 65, becomes disabled at age 55. The plan applies a reduction to the monthly benefit for early commencement if the participant commences benefits before age 65. For a participant who commences receiving benefits at age 55, the actuarially adjusted early retirement benefit is 60% of the accrued benefit. However, the plan also provides that if a participant becomes entitled to an early retirement benefit on account of disability, as defined in the plan, the benefit is not reduced. On account of a disability, the participant commences an unreduced early retirement benefit of $1,000 per month at age 55 (instead of the $600 monthly benefit the participant would receive if the participant were not disabled). The participant continues to receive $1,000 per month after reaching age 65.

(ii) *Conclusion*. The participant's disability benefit payment of $1,000 per month commencing at age 55 is a benefit based on disability, even though the participant would have received a portion of these benefits at retirement regardless of the disability. Thus, both before and after attaining age 65, the participant's entire monthly payment amount ($1,000) is a benefit based on disability. A suspension of benefits is not permitted to apply to any portion of the participant's benefit at any time.

*Example 2*. (i) *Facts*. The facts are the same as *Example 1*, except that the terms of the plan provide that when a disabled participant reaches age 65, the disability pension is discontinued by reason of reaching age 65, and the retirement benefits commence. In this case, the amount of the participant's retirement benefits is the same as the amount that the participant was receiving immediately before commencing retirement benefits, or $1,000.

(ii) *Conclusion*. Before age 65, the participant's disability benefit payment of $1,000 per month commencing at age 55 is a benefit based on disability. After age 65, the periodic retirement benefit of $1,000 per month is a benefit based on disability because it does not exceed the benefit based on disability that the participant was receiving immediately before commencing retirement benefits. Thus, both before and after attaining age 65, the participant's entire monthly payment amount ($1,000) is a benefit based on disability. A suspension of benefits is not permitted to apply to any portion of the participant's benefit at any time.

*Example 3. (i) Facts*. The facts are the same as *Example 2*, except that upon reaching age 65, the participant elects to commence payment of retirement benefits not in the form of a single life annuity payable in the amount of $1,000 per month but instead in the form of an actuarially equivalent joint and survivor annuity payable in the amount of $850 per month.

(ii) *Conclusion*. Before age 65, the participant's benefit based on disability is $1,000 per month. After age 65, the participant's entire retirement benefit of $850 per month is a benefit based on disability because it does not exceed the benefit based on disability that the participant was receiving immediately before commencing retirement benefits. Thus, a suspension of benefits is not permitted to apply to any portion of those benefits at any time.

*Example 4*. (i) *Facts*. A participant's disability pension is a specified amount unrelated to the participant's accrued benefit. The participant's disability benefit commencing at age 55 is $750 per month. Upon reaching age 65, the participant's disability pension is discontinued by reason of reaching age 65 and the participant elects to receive an accrued benefit payable in the amount of $1,000 per month.

(ii) *Conclusion*. Before age 65, the participant's benefit based on disability is $750 per month. After age 65, the participant's benefit based on disability continues to be $750 per month (even though the participant's payment is $1,000 per month), because the benefit based on disability is the lesser of the periodic disability pension the participant was receiving immediately before retirement benefits commenced ($750) and the periodic payment of retirement benefits to the participant under the plan determined without regard to the suspension ($1,000). Thus, a suspension of benefits is not permitted to reduce the participant's benefit based on disability ($750 per month) at any time.

*Example 5*. (i) *Facts*. The facts are the same as *Example 2*, except that when the participant attains age 65, the participant's monthly benefit payment increases from $1,000 to $1,300 as a result of the plan providing additional accruals during the period of disability, as if the participant were not disabled.

(ii) *Conclusion*. As in *Example 2*, before age 65, the participant's benefit payment of $1,000 per month commencing at age 55 is a benefit based on disability. After age 65, the participant's benefit payment of $1,300 per month is a benefit based on disability because the $1,300 is payable based on additional accruals earned pursuant to the participant becoming disabled. Thus, both before and after attaining age 65, the participant's entire monthly payment amount is a benefit based on disability. A suspension of benefits is not permitted to apply to any portion of the participant's benefit at any time.

*Example 6*. (i) *Facts*. The facts are the same as *Example 3* of paragraph (d)(2)(v) of this section, except that the social security level income option is only available to a participant who incurs a disability as defined in the plan.

(ii) *Conclusion*. Before normal retirement age, the participant's benefit payment of $1,600 per month is a benefit based on disability. After normal retirement age, the participant's benefit based on disability is $900, which is the lesser of the $1,600 periodic payment that the participant was receiving immediately before the participant's normal retirement benefit commenced and the participant's $900 periodic payment of retirement benefits determined without regard to the suspension. Thus, a suspension of benefits is not permitted to apply to any portion of those benefits ($1,600 per month before and $900 per month after normal retirement age) at any time.

*Example 7*. (i) *Facts*. A plan applies a reduction to the monthly benefit for early commencement if a participant commences benefits before age 65. The plan also provides that if a participant becomes disabled, as defined in the plan, the benefit that is paid before normal retirement age is not reduced for early retirement. Under the plan, when a disabled participant reaches age 65, the disability pension is discontinued by reason of reaching age 65 and the retirement benefits commence. A participant with a vested accrued benefit of $1,000 per month, payable at age 65, becomes disabled at age 55. On account of the disability, the participant commences benefits at age 55 in the amount of $1,000 per month (instead of the $600 monthly benefit the participant could have received at that age if the participant were not disabled). The participant recovers from the disability at age 60, and the participant's disability benefits cease. At age 60, the participant immediately elects to begin an early retirement benefit of $800.

(ii) *Conclusion*. The participant's disability benefit payment of $1,000 per month commencing at age 55 is a benefit based on disability, even though the participant would have received a portion of these benefits at retirement regardless of the disability. Because the participant ceased receiving disability benefits on account of the participant no longer being disabled (and not solely on account of commencing retirement benefits), the participant's early retirement benefit of $800 per month that began after the disability benefit ended is not a benefit based on disability.

(5) *Limitation on aggregate size of suspension*—(i) *General rule*. Any suspension of benefits (considered, if applicable, in combination with a partition of the plan under section 4233 of ERISA (partition)) must be at a level that is reasonably estimated to—

(A) Enable the plan to avoid insolvency; and

(B) Not materially exceed the level that is necessary to enable the plan to avoid insolvency.

(ii) *Suspension sufficient to avoid insolvency*—(A) *General rule*. A suspension of benefits (considered, if applicable, in combination with a partition of the plan) will satisfy the requirement that it is at a level that is reasonably estimated to enable the plan to avoid insolvency if—

(*1*) For each plan year throughout an extended period (as described in paragraph (d)(5)(ii)(C) of this section) beginning on the first day of the plan year that includes the effective date of the suspension, the plan's solvency ratio is projected on a deterministic basis to be at least 1.0;

(*2*) Based on stochastic projections reflecting variance in investment return, the probability that the plan will avoid insolvency throughout the extended period is more than 50 percent; and

(*3*) Unless the plan's projected funded percentage (within the meaning of section 432(j)(2)) at the end of the extended period using the deterministic projection described in paragraph (d)(5)(ii)(A)(*1*) of this section exceeds 100 percent, that projection shows that, during each of the last five plan years of that period, neither the plan's solvency ratio nor its available resources (as defined in section 418E(b)(3)) is projected to decrease.

(B) *Solvency ratio*. For purposes of this section, a plan's solvency ratio for a plan year means the ratio of—

(*1*) The plan's available resources (as defined in section 418E(b)(3)) for the plan year; to

(*2*) The scheduled benefit payments under the plan for the plan year.

(C) *Extended period*. For purposes of this section, an extended period means a period of at least 30 plan years. However, in the case of a temporary suspension of benefits that is scheduled to cease as of a date that is more than 25 years after the effective date, the extended period must be lengthened so that it ends no earlier than five plan years after the cessation of the suspension.

(iii) *Suspension not materially in excess of level necessary to avoid insolvency*—(A) *General rule*. A suspension of benefits will satisfy the requirement under paragraph (d)(5)(i)(B) of this section that the suspension be at a level that is reasonably estimated to not materially exceed the level necessary for the plan to avoid insolvency only if an alternative, similar but smaller suspension of benefits would not be sufficient to enable the plan to satisfy the requirement to avoid insolvency under paragraph (d)(5)(i)(A) of this section (determined using an extended period that is no shorter than the extended period used to satisfy the requirements of paragraph (d)(5)(i)(A) of this section). The alternative suspension of benefits that is used for this purpose is a suspension of benefits under which, for each participant or beneficiary, the amount of the reduction in the periodic payment (determined after application of the individual limitations) is equal to the amount of the reduction proposed for that participant or beneficiary in the application submitted pursuant to paragraph (g) of this section, decreased (but not below zero) by the greater of—

(*1*) Five percent of the amount of the reduction in the periodic payment proposed for that participant or beneficiary; or

(*2*) Two percent of the amount of the participant's or beneficiary's periodic payment determined without regard to the reduction proposed in the application.

(B) *Special rule for partitions*. If PBGC issues an order partitioning the plan, then a suspension of benefits with respect to the plan will be deemed to satisfy the requirement under paragraph (d)(5)(i)(B) of this section that the suspension be at a level that is reasonably estimated to not materially exceed the level necessary for the plan to avoid insolvency.

(iv) *Actuarial basis for projections*—(A) *In general*. This paragraph (d)(5)(iv) sets forth rules for the actuarial projections that are required under this paragraph (d)(5). The projections must reflect the assumption that the suspension of benefits continues indefinitely (or, if the suspension expires on a specified date by its own terms, until that date).

(B) *Reasonable actuarial assumptions and methods*. Each of the actuarial assumptions and methods used for the actuarial projections that are required under this paragraph (d)(5), and the combination of those actuarial assumptions and methods, must be reasonable, taking into account the experience of the plan and reasonable expectations. To be reasonable, the actuarial assumptions and methods must also be appropriate for the purpose of the measurement (this means that factors specific to the measurements must be taken into account). The actuary's selection of assumptions about future covered employment and contribution levels (including contribution base units and average contribution rate) may be based on information provided by the plan sponsor, which must act in good faith in providing the information. In addition, to the extent that an actuarial assumption used for the deterministic projection in paragraph (d)(5)(ii)(A)(*1*) of this section differs from that used to certify whether the plan is in critical and declining status pursuant to section 432(b)(3)(B)(iv), an explanation of the information and analysis that led to the selection of that different assumption must be provided. Similarly, to the extent that an actuarial assumption used for the stochastic projection in paragraph (d)(5)(ii)(A)(*2*) of this section differs from that used for the deterministic projection, an explanation of the information and analysis that led to the selection of that different assumption must be provided.

(C) *Initial value of plan assets and cash flow projections*. Except as provided in paragraph (d)(5)(iv)(D) of this section, the cash flow projections must be based on—

(*1*) The fair market value of plan assets as of the end of the calendar quarter immediately preceding the date the application is submitted;

(*2*) Projected benefit payments that are consistent with the projected benefit payments under the most recent actuarial valuation; and

(*3*) Appropriate adjustments to projected benefit payments to include benefits for new hires who are reflected in the projected contribution amounts.

(D) *Requirement to reflect significant events*. The projected cash flows relating to contributions, withdrawal liability payments, and benefit payments must also be adjusted to reflect significant events that occurred after the most recent actuarial valuation. Significant events include—

(*1*) A plan merger or transfer;

(*2*) The withdrawal or the addition of employers that changed projected cash flows relating to contributions, withdrawal liability payments, or benefit payments by more than five percent;

(*3*) A plan amendment, a change in a collective bargaining agreement, or a change in a rehabilitation plan that changed projected cash flows relating to contributions, withdrawal liability payments, or benefit payments by more than five percent; or

(*4*) Any other event or trend that resulted in a material change in those projected cash flows.

(v) *Simplified determination for smaller plans*. In the case of a plan that is not large enough to be required to select a retiree representative under paragraph (b)(4) of this section, the determination of whether the benefit suspension (or a benefit suspension in combination with a partition of the plan) will satisfy the requirement that it is at a level that is reasonably estimated to enable the plan to avoid insolvency is permitted to be made without regard to paragraph (d)(5)(ii)(A)(*2*) of this section.

(vi) *Additional disclosure*—(A) *Disclosure of past experience for critical assumptions*. The application for suspension must include a disclosure of the total contributions, total contribution base units and average contribution rate, withdrawal liability payments, and the rate of return on plan assets for each of the 10 plan years preceding the plan year in which the application is submitted.

(B) *Sensitivity of results to investment return assumptions*. The application must include deterministic projections of the plan's solvency ratio over the extended period using two alternative assumptions for the plan's rate of return. These alternatives are that the plan's future rate of return will be lower than the assumed rate of return used under paragraph (d)(5)(iv)(B) of this section by—

(*1*) One percentage point; and

(*2*) Two percentage points.

(C) *Sensitivity of results to industry level assumptions*. The application must include deterministic projections of the plan's solvency ratio over the extended period using two alternative assumptions for future contribution base units. These alternatives are that future contribution base units—

(*1*) Continue under the same trend as the plan experienced over the past 10 years; and

(*2*) Continue under the trend identified in paragraph (d)(5)(vi)(C)(*1*) of this section reduced by one percentage point.

(D) *Projection of funded percentage*. The application must include an illustration, prepared on a deterministic basis, of the projected value of plan assets, the accrued liability of the plan (calculated using the unit credit funding method), and the funded percentage for each year in the extended period.

(E) *Permitted simplification of certain projections*. It is permissible for the projections described in paragraph (d)(5)(vi)(C) of this section to be made without reflecting any adjustments to the projected benefit payments that result from the alternative assumptions regarding future contribution base units.

(6) *Equitable distribution*—(i) *In general*. Any suspension of benefits must be equitably distributed across the participant and beneficiary population, taking into account factors, with respect to participants and beneficiaries and their benefits, that may include one or more of the factors described in paragraph (d)(6)(ii) of this section. If a suspension of benefits provides for different treatment for different participants and beneficiaries (other than as a result of application of the individual limitations), then the suspension of benefits is equitably distributed across the participant and beneficiary population only if—

(A) Under the suspension, the participants and beneficiaries are divided into separate categories or groups that are defined by the consistent treatment of individuals within each separate category or group;

(B) Any difference in treatment under the suspension of benefits among the different categories or groups is based on relevant factors reasonably selected by the plan sponsor, such as the factors described in paragraph (d)(6)(ii) of this section; and

(C) Any such difference in treatment is based on a reasonable application of those relevant factors.

(ii) *Factors that may be considered*—(A) *In general*. In accordance with paragraph (d)(6)(i)(B) and (C) of this section, if, under the suspension, there is any difference between the treatment of one category or group of participants and beneficiaries and another category or group of participants and beneficiaries, that difference must be based on a reasonable application of relevant statutory factors described in paragraph (d)(6)(ii)(B) of this section and any other factors reasonably selected by the plan sponsor. For example, it would be reasonable for a plan sponsor to conclude that the statutory factor described in paragraph (d)(6)(ii)(B)(*3*) of this section (amount of benefit) is a factor that should be taken into account as justifying a lesser benefit reduction for participants or beneficiaries whose benefits are closer to the level of the PBGC guarantee than for others. In addition, it would be reasonable for a plan sponsor to conclude that the presumed financial vulnerability of certain participants or beneficiaries who are reasonably deemed to be in greater need of protection than other participants or beneficiaries is a factor that should be taken into account as justifying a lesser benefit reduction (as a percentage or otherwise) for those participants or beneficiaries than for others.

(B) *Statutory factors*. Factors that may be selected as a basis for differences in treatment under a suspension of benefits include, when reasonable under the circumstances, the following statutory factors:

(*1*) The age and life expectancy of the participant or beneficiary;

(*2*) The length of time that benefits have been in pay status;

(*3*) The amount of benefits;

(*4*) The type of benefit, such as survivor benefit, normal retirement benefit, or early retirement benefit;

(*5*) The extent to which a participant or beneficiary is receiving a subsidized benefit;

(*6*) The extent to which a participant or beneficiary has received post-retirement benefit increases;

(*7*) The history of benefit increases and reductions for participants and beneficiaries;

(*8*) The number of years to retirement for active employees;

(*9*) Any differences between active and retiree benefits;

(*10*) The extent to which active participants are reasonably likely to withdraw support for the plan, accelerating employer withdrawals from the plan and increasing the risk of additional benefit reductions for participants in and out of pay status; and

(*11*) The extent to which a participant's or beneficiary's benefits are attributable to service with an employer that failed to pay its full withdrawal liability.

(iii) *Reasonable application of factors*. An application of a factor referred to in paragraph (d)(6)(ii) of this section is unreasonable if it is inconsistent with the protections provided by the individual limitations described in paragraphs (d)(2) through (d)(4) of this section. For example, it would constitute an unreasonable application of the factor described in paragraph (d)(6)(ii)(B)(*3*) of this section (amount of benefit) if that factor were used to justify a larger suspension for participants whose benefits are closer to the guarantee-based limitation. Similarly, it would constitute an unreasonable application of the factors described in paragraph (d)(6)(ii)(B)(*1*) of this section (age and life expectancy of the participant or beneficiary) if those factors were used to justify a greater suspension for older participants.

(iv) *Special rule for identification of categories or groups*—(A) *New post-suspension benefit formula*. This paragraph (d)(6)(iv) applies in the case of a proposed suspension of benefits under which an individual's benefits after suspension are calculated under a new benefit formula (rather than by reference to the individual's benefits before suspension). In this case, the evaluation of whether the proposed suspension is equitably distributed across the participant and beneficiary population is based on a comparison of an individual's pre-suspension benefit to the individual's post-suspension benefit (determined without regard to the application of the individual limitations). Accordingly, all individuals whose pre-suspension benefits are determined under a uniform pre-suspension benefit formula and whose post-suspension benefits are determined under a different uniform post-suspension benefit formula are treated as a single group.

(B) *Blended pre-suspension benefit formula*. If a plan applies different pre-suspension benefit formulas with respect to different plan years, then all individuals to whom more than one such formula applied may be treated as having a uniform pre-suspension benefit formula for purposes of paragraph (d)(6)(iv)(A) of this section (even though those individuals have different proportions of their pre-suspension benefits calculated under the different benefit formulas).

(C) *Changes in early retirement factors*. For purposes of paragraph (d)(6)(iv)(A) of this section, two individuals are not treated as having different pre-suspension or post-suspension benefit formulas merely because, as a result of the application of a uniform set of early retirement factors, their benefits differ because of retirement at different ages.

(v) *Examples*. The following examples illustrate the rules on equitable distribution of a suspension of benefits of this paragraph (d)(6). As a simplifying assumption for purposes of these examples, it is assumed that the facts of each example describe all of the factors that are included in the application discussed in the example (provided, however, that, in the case of a plan described in section 432(e)(9)(D)(vii), the examples are not intended to illustrate the application of section 432(e)(9)(D)(vii) or its effect on the analysis or conclusions in the examples).

*Example 1*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits on March 15, 2017. Under the plan terms applicable prior to the suspension, one group of participants benefitted only under Benefit Formula A and the remaining participants benefitted only under Benefit Formula B. Each of these benefit formulas is uniform. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, benefits for all participants are reduced so that a uniform post-suspension benefit formula (Benefit Formula C) applies to all participants.

(ii) *Conclusion*. Because the reduction in benefits under the suspension formula is different for participants who benefitted only under Benefit Formula A than for participants who benefitted only under Benefit Formula B, the suspension of benefits provides for different treatment for different participants and beneficiaries (other than as a result of application of the individual limitations). In addition, the suspension of benefits provides for consistent treatment of participants within the following two categories: (1) participants who benefitted only under Benefit Formula A; and (2) participants who benefitted only under Benefit Formula B. Therefore, pursuant to paragraph (d)(6)(iv)(A) of this section, these two categories of participants are each treated as a single group for purposes of evaluating whether the proposed suspension is equitably distributed across the participant and beneficiary population. In order to demonstrate that the distribution of the suspension satisfies the equitable distribution requirement, the plan sponsor must reasonably select and apply factors that are the basis for the different treatment of these two groups of participants.

*Example 2*. (i) *Facts*. The facts are the same as in *Example 1*, except that the plan terms applicable prior to the suspension did not provide for different benefit formulas for different groups of participants at any given time. Instead, the plan terms provided that different uniform benefit formulas applied for service prior to January 1, 2000, and for service on or after January 1, 2000.

(ii) *Conclusion*. The reduction in benefits under the suspension formula is different for participants who had service only prior to January 1, 2000, participants who had service only after January 1, 2000, and participants who had service during both of those periods. The suspension of benefits provides for different treatment for different participants and beneficiaries (other than as a result of application of the individual limitations). In addition, the suspension of benefits provides for consistent treatment of participants within the following three categories of participants: (1) participants whose entire service was prior to January 1, 2000, (2) participants whose entire service was on or after January 1, 2000, and (3) participants who have some service before January 1, 2000 and some service on or after January 1, 2000. Therefore, pursuant to paragraph (d)(6)(iv)(A) of this section, the two categories of participants whose entire service was either before or on or after January 1, 2000 are each treated as a single group for purposes of evaluating whether the proposed suspension is equitably distributed across the participant and beneficiary population. In addition, pursuant to paragraph (d)(6)(iv)(B) of this section, the category of participants with some service before January 1, 2000 and some service on or after January 1, 2000 is treated as a single group for purposes of this evaluation. In order to demonstrate that the distribution of the suspension satisfies the equitable distribution requirement, the plan sponsor must reasonably select and apply factors that are the basis for the different treatment of these three categories of participants.

*Example 3*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, benefits for all participants and beneficiaries are reduced by the same percentage, and the suspension application indicates the rationale for this reduction.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations.

*Example 4*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the age-based and disability-based limitations of section 432(e)(9)(D)(ii) and (iii), the portion of each participant's and beneficiary's benefit that exceeds the guarantee-based limitation of section 432(e)(9)(D)(i) is reduced by the same percentage, and the suspension application indicates the rationale for this reduction.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations. The result would be the same if, instead, the suspension of benefits applies only to benefits that exceed a multiple (in excess of 100%) of the guarantee-based limitation.

*Example 5*. (i) *Facts*. A plan was previously amended to provide an ad hoc 15% increase to the benefits of all participants and beneficiaries (including participants who, at the time, were no longer earning service under the plan, which therefore included retirees and deferred vested participants). The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, benefits for all participants and beneficiaries who were no longer earning service under the plan at the time of the ad hoc amendment are reduced by eliminating the amendment for those individuals. The suspension application indicates why the benefit reduction is based on the statutory factors in paragraph (d)(6)(ii)(B)(*6*) of this section (the extent to which a participant or beneficiary has received post-retirement benefit increases), including application of the reduction to those who, at the time of the previous benefit increase, were either retired participants or deferred vested participants, and in paragraph (d)(6)(ii)(B)(*7*) of this section (the history of benefit increases and reductions), and why it is reasonable to apply the factors in this manner.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations. This is because the difference in treatment between the two groups of participants is based on whether a participant has received post-retirement benefit increases (in this case, whether a participant was earning service under the plan at the time of the benefit increase amendment), which under these facts is a relevant factor that may be reasonably selected by the plan sponsor, and the difference in treatment between the two groups of participants (eliminating the amendment only for benefits with respect to participants who were no longer earning service at the time of the amendment) is based on a reasonable application of that factor.

*Example 6*. (i) *Facts*. A plan contains a provision that provides a "thirteenth check" in plan years for which the investment return is greater than 7% (which was the assumed rate of return under the plan's actuarial valuation). The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, benefits for all participants and beneficiaries are reduced by eliminating the "thirteenth check" for all of those individuals. The suspension application indicates why the benefit reduction is based on the statutory factors in paragraph (d)(6)(ii)(B)(*6*) of this section (the extent to which a participant or beneficiary has received post-retirement benefit increases) and in paragraph (d)(6)(ii)(B)(*7*) of this section (the history of benefit increases and reductions), and why it is reasonable to apply the factors in this manner.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations.

*Example 7*. (i) *Facts*. A plan was previously amended to reduce future accruals from $60 per year of service to $50 per year of service. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, the accrued benefits for all participants and beneficiaries are reduced to $50 per year of service (and the plan's generally applicable adjustments for early retirement and form of benefit apply). The suspension application indicates why the benefit reduction is based on the statutory factor in paragraph (d)(6)(ii)(B)(*7*) of this section (the history of benefit increases and reductions), and why it is reasonable to apply the factors in this manner.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations. This is because the difference in treatment among the different groups of participants is based on the history of benefit reductions and a discrepancy between active and retiree benefits, which under these facts are relevant factors that may be reasonably selected by the plan sponsor, and the difference in treatment between the three groups of participants (reducing the $60 benefit multiplier to $50 per year of service for two groups of participants—those who had accrued all of their benefits under the $60 multiplier and those who had accrued some of their benefits under the $60 multiplier—and not reducing benefits for the group of participants who had accrued all of their benefits under the $50 multiplier) is based on a reasonable application of those factors.

*Example 8*. (i) *Facts*. The facts are the same as in *Example 7*, except that no plan amendments have previously reduced future accruals or other benefits for active participants. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, benefits for deferred vested participants, retirees, and beneficiaries who have commenced benefits are reduced, but no reduction applies to active participants. The suspension of benefits is not accompanied by any reductions in future accruals or other benefits for active participants.

(ii) *Conclusion*. The suspension of benefits is not equitably distributed across the participant and beneficiary populations. This is because, under these facts, no relevant factor (such as a previous reduction in benefits applicable only to active participants) has been reasonably selected by the plan sponsor to justify the proposed difference in treatment among the categories.

*Example 9*. (i) *Facts*. The facts are the same as in *Example 8*, except that the suspension of benefits provides for a reduction that applies to both active and inactive participants. However, the reduction that applies to active participants is smaller than the reduction that applies to inactive participants because the plan sponsor concludes, as explained and supported in the application for suspension, that active participants are reasonably likely to withdraw support for the plan if any larger reduction is applied.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations. This is because the difference in treatment between the different groups of participants is based on the extent to which active participants are reasonably likely to withdraw support for the plan, which under these facts is a relevant factor that may reasonably be selected by the plan sponsor, and the difference in treatment between the two groups of participants (applying a greater suspension to inactive than to active participants) is based on a reasonable application of that factor.

*Example 10*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, the benefits for participants and beneficiaries attributable to service with an employer that failed to pay its full withdrawal liability are reduced by 50%. As indicated in the suspension application, the present value of the benefit reduction with respect to the former employees of one such employer is significantly greater than the unpaid withdrawal liability for that employer. Benefits for participants and beneficiaries attributable to service with all other employers are reduced by 10%.

(ii) *Conclusion*. The suspension of benefits is not equitably distributed across the participant and beneficiary populations. This is because, although the difference in treatment between the different groups of participants is based on a relevant factor that may reasonably be selected by the plan sponsor, the difference in treatment between the groups of participants is not based on a reasonable application of that factor.

*Example 11*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, the benefits for all participants and beneficiaries are reduced by the same percentage, except that the benefits for employees and former employees of a particular employer that is actively represented on the plan's Board of Trustees are reduced by a specified lesser percentage.

(ii) *Conclusion*. The suspension of benefits is not equitably distributed across the participant and beneficiary populations. This is because, under these facts, no relevant factor has been reasonably selected by the plan sponsor to justify the difference in treatment between the two groups of participants.

*Example 12*. (i) *Facts*. The facts are the same as in *Example 11*, except that the particular employer whose employees and former employees are subject to the lesser benefit reduction is the union that also participates in the plan.

(ii) *Conclusion*. The suspension of benefits is not equitably distributed across the participant and beneficiary populations. This is because, under these facts, no relevant factor has been reasonably selected by the plan sponsor to justify the difference in treatment between the two groups of participants.

*Example 13*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, the monthly benefit of all participants and beneficiaries is reduced to 110% of the monthly benefit that is guaranteed by PBGC under section 4022A of ERISA. As indicated in the suspension application, this is because the plan sponsor is applying to PBGC for a partition of the plan, which requires the plan sponsor to have implemented the maximum benefit suspensions under section 432(e)(9).

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations.

*Example 14*. (i) *Facts*. The plan sponsor applies for approval of a suspension of benefits. Under the suspension of benefits, subject to the individual limitations on benefit suspensions, benefits for all participants and beneficiaries are reduced by the same percentage, except that the protection for benefits based on disability goes beyond the required disability-based limitations and also includes payments to a beneficiary of a participant who had been receiving benefits based on disability at the time of death. The suspension application indicates the rationale for this protection from reduction.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations because this suspension design is a reasonable application of the statutory factor in paragraph (d)(6)(ii)(B)(*4*) of this section (type of benefit).

*Example 15*. (i) *Facts*. The facts are the same as in *Example 3*, except that the plan does not provide for benefits based on disability. Under the suspension of benefits, less of a reduction is applied to a participant who has become disabled within the meaning of title II of the Social Security Act than to otherwise similarly situated participants and the suspension application indicates the rationale for this reduction.

(ii) *Conclusion*. The suspension of benefits is equitably distributed across the participant and beneficiary populations because a participant's disability within the meaning of title II of the Social Security Act is a factor that can reasonably be taken into account in designing a suspension of benefits and applying less of a reduction to an individual in this group is a reasonable application of that factor.

(7) *Effective date of suspension made in combination with partition*. In any case in which a suspension of benefits with respect to a plan is made in combination with a partition of the plan, the suspension of benefits may not take effect prior to the effective date of the partition. This requirement will not be satisfied if the partition order under section 4233 of ERISA has not been provided to the Secretary of the Treasury by the last day of the 225-day period described in paragraph (g)(3)(i) of this section. For purposes of the preceding sentence, a conditional approval by PBGC (within the meaning of 29 CFR 4233.12(c)) of a partition application that is conditioned only on the Secretary's issuing a final authorization to suspend is treated as a partition order.

(8) *Additional rules for plans described in section 432(e)(9)(D)(vii)*. [Reserved].

(e) *Benefit improvements*—(1) *Limitations on benefit improvements*. This paragraph (e) sets forth rules for the application of section 432(e)(9)(E). A plan satisfies the criteria in section 432(e)(9)(E) only if, during the period that any suspension of benefits remains in effect, the plan sponsor does not implement any benefit improvement with respect to the plan except as provided in this paragraph (e). Paragraph (e)(2) of this section describes limitations on a benefit improvement for participants and beneficiaries who are not yet in pay status. Paragraph (e)(3) of this section describes limitations on a benefit improvement for participants and beneficiaries who are in pay status. Paragraph (e)(4) of this section provides that the limitations of this paragraph (e) generally apply in addition to other limitations on benefit increases that apply to a plan. Paragraph (e)(5) of this section defines benefit improvement.

(2) *Limitations on benefit improvements for those not in pay status*—(i) *Equitable distribution for those in pay status and solvency projection*. During the period that any suspension of benefits under a plan remains in effect, the plan sponsor may not increase the liabilities of the plan by reason of any benefit improvement for any participant or beneficiary who was not in pay status by the first day of the plan year for which the benefit improvement takes effect, unless—

(A) The present value of the total liabilities for a benefit improvement for participants and beneficiaries whose benefit commencement dates were before the first day of the plan year for which the benefit improvement takes effect is not less than the present value of the total liabilities for a benefit improvement for participants and beneficiaries who were not in pay status by that date;

(B) The plan sponsor equitably distributes the benefit improvement among the participants and beneficiaries whose benefit commencement dates were before the first day of the plan year in which the benefit improvement is proposed to take effect; and

(C) The plan actuary certifies that after taking into account the benefit improvement, the plan is projected to avoid insolvency indefinitely.

(ii) *Rules of application*—(A) *Present value determination*—(*1*) *Actuarial assumptions and methods*. For purposes of paragraph (e)(2)(i)(A) of this section, the present value of the total liabilities for a benefit improvement is the present value as of the first day of the plan year in which the benefit improvement is proposed to take effect. The actuarial assumptions and methods used for the calculation for present values and the actuarial projections that are required under this paragraph (e)(2) must each be reasonable, and the combination of the actuarial assumptions and methods must be reasonable, taking into account the experience of the plan and reasonable expectations.

(*2*) *Increase in future accrual rate*. In the case of a benefit improvement that is an increase in the rate of future accrual, the present value determined under paragraph (e)(2)(i)(A) of this section must take into account the increase in accruals for participants and beneficiaries not yet in pay status for all future years.

(B) *Factors relevant to equitable distribution*. The evaluation of whether a benefit improvement is equitably distributed for purposes of paragraph (e)(2)(i)(B) of this section must take into account the relevant factors described in paragraph (d)(6)(ii)(B) of this section and the extent to which the benefits of the participants and beneficiaries were suspended.

(C) *Actuarial certification*. The certification in paragraph (e)(2)(i)(C) of this section must be made using the standards described in paragraphs (d)(5)(ii), (iv), and (v) of this section, substituting the plan year that includes the effective date of the benefit improvement for the plan year that includes the effective date of the suspension.

(iii) *Special rule for certain benefit increases*. The limitations of this paragraph (e) do not apply to a resumption of suspended benefits or plan amendment that increases liabilities with respect to participants and beneficiaries not in pay status by the first day of the plan year in which the benefit improvement took effect that—

(A) The Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, determines to be reasonable and which provides for only *de minimis* increases in the liabilities of the plan; or

(B) Is required as a condition of qualification under section 401 or to comply with other applicable law, as determined by the Secretary of the Treasury.

(3) *Limitation on resumption of suspended benefits only for those in pay status*. The plan sponsor may increase liabilities of the plan by eliminating some or all of the suspension that applies solely to participants and beneficiaries in pay status at the time of the resumption, provided that the plan sponsor equitably distributes the value of those resumed benefits among participants and beneficiaries in pay status, taking into account the relevant factors described in paragraph (d)(6)(ii)(B) of this section. A resumption of benefits that is described in this paragraph (e)(3) is not subject to the limitations on a benefit improvement under section 432(f) (relating to restrictions on benefit increases for plans in critical status).

(4) *Additional limitations*. Except as provided in paragraph (e)(3) of this section, the limitations on a benefit improvement under this paragraph (e) are in addition to the limitations in section 432(f) and any other applicable limitations on increases in benefits imposed on a plan.

(5) *Definition of benefit improvement*—(i) *In general*. For purposes of this paragraph (e), the term benefit improvement means, with respect to a plan, a resumption of suspended benefits, an increase in benefits, an increase in the rate at which benefits accrue, or an increase in the rate at which benefits become nonforfeitable, under the plan.

(ii) *Effect of expiration of suspension*. In the case of a suspension of benefits that expires as of a date that is specified in the plan amendment implementing the suspension, the resumption of benefits solely from the expiration of that period is not treated as a benefit improvement.

(f) *Notice requirements*—(1) *In general*. No suspension of benefits may be made pursuant to this section unless notice of the proposed suspension has been given by the plan sponsor to—

(i) All participants, beneficiaries of deceased participants, and alternate payees under the plan (regardless of whether their benefits are proposed to be suspended), except those who cannot be contacted by reasonable efforts;

(ii) Each employer who has an obligation to contribute (within the meaning of section 4212(a) of ERISA) under the plan; and

(iii) Each employee organization which, for purposes of collective bargaining, represents plan participants employed by an employer described in paragraph (f)(1)(ii) of this section.

(2) *Content of notice*—(i) *In general*. The notice described under paragraph (f)(1) of this section must contain—

(A) Sufficient information to enable a participant or beneficiary to understand the effect of any suspension of benefits, including an individualized estimate (on an annual or monthly basis) of the effect on that participant or beneficiary;

(B) A description of the factors considered by the plan sponsor in designing the benefit suspension;

(C) A statement that the application for approval of any suspension of benefits will be available on the website of the Department of the Treasury and that comments on the application will be accepted;

(D) Information as to the rights and remedies of plan participants and beneficiaries;

(E) If applicable, a statement describing the appointment of a retiree representative, the date of appointment of the representative, the role and responsibilities of the retiree representative, identifying information about the retiree representative (including whether the representative is a plan trustee), and how to contact the retiree representative; and

(F) Information on how to contact the Department of the Treasury for further information and assistance where appropriate.

(ii) *Description of suspension of benefits*. The notice described under paragraph (f)(1) of this section will not satisfy the requirements of paragraph (f)(2)(i) of this section unless it includes the following—

(A) To the extent that it is not possible to provide an individualized estimate on an annual or monthly basis of the quantitative effect of the suspension on a participant or beneficiary, such as in the case of a suspension that affects the payment of any future cost-of-living adjustment, that effect may be reflected in a narrative description;

(B) A statement that the plan sponsor has determined that the plan will become insolvent unless the proposed suspension takes effect, and the year in which insolvency is projected to occur without a suspension of benefits;

(C) A statement that insolvency of the plan could result in benefits lower than benefits paid under the proposed suspension and a description of the projected benefit payments upon insolvency;

(D) A description of the proposed suspension and its effect, including a description of the different categories or groups affected by the suspension, how those categories or groups are defined, and the formula that is used to calculate the amount of the proposed suspension for individuals in each category or group;

(E) A description of the effect of the proposed suspension on the plan's projected insolvency;

(F) A description of whether the suspension will remain in effect indefinitely, or the date the suspension expires if it expires by its own terms; and

(G) A statement describing the right to vote on the suspension application.

(iii) *Readability requirement*. A notice given under paragraph (f)(1) of this section must be written in a manner so as to be understood by the average plan participant.

(iv) *Model notice*. The Secretary of the Treasury will provide a model notice. The use of the model notice will satisfy the content and readability requirements of this paragraph (f)(2) with respect to the language provided in the model.

(3) *Form and manner*—(i) *Timing*—(A) *In general*. A notice under paragraph (f)(1) of this section must be given no earlier than four business days before the date on which an application is submitted and no later than two business days after the Secretary of the Treasury notifies the plan sponsor that it has submitted a complete application, as described in paragraph (g)(1)(ii) of this section.

(B) *Timing for lost participants*. If additional individuals who are entitled to notice are located after the time period in paragraph (f)(3)(i)(A) of this section has elapsed, then the plan sponsor must give notice to these individuals as soon as practicable thereafter.

(ii) *Method of delivery of notice*—(A) *Written or electronic delivery*. A notice given under paragraph (f)(1) of this section may be provided in writing. It may also be provided in electronic form to the extent that the form is reasonably accessible to persons to whom the notice is required to be provided. Permissible electronic methods include those permitted under regulations of the Department of Labor at 29 CFR § 2520.104b–1(c) and those described at § 54.4980F–1, Q&A–13(c) of the Excise Tax Regulations.

(B) *No alternative method of delivery*. A notice under this paragraph (f) must be provided in written or electronic form.

(iii) *Additional information in notice*. A notice given under paragraph (f)(1) of this section is permitted to include information in addition to the information that is required under paragraph (f)(2) of this section, including, if applicable, information relating to an application for partition under section 4233 of ERISA (such as the model notice at Appendix A of 29 CFR part 4233), provided that the requirements of paragraph (f)(3)(iv) of this section are satisfied.

(iv) *No false or misleading information*. A notice given under paragraph (f)(1) of this section may not include false or misleading information (or omit information in a manner that causes the information provided to be misleading).

(4) *Other notice requirement*. Any notice given under paragraph (f)(1) of this section satisfies the requirement for notice of a significant reduction in benefits described in section 4980F that would otherwise be required as a result of that suspension of benefits. To the extent that there are other reductions that accompany a suspension of benefits, such as a reduction in the future accrual rate described in section 4980F for active participants or a reduction in adjustable benefits under section 432(e)(8), notice that satisfies the requirements (including the applicable timing requirements) of section 4980F or section 432(e)(8), as applicable, must be provided.

(5) *Examples*. The following examples illustrate the requirement in paragraph (f)(1)(i) of this section to give notice to all participants, beneficiaries of deceased participants, and alternate payees, except those who cannot be contacted by reasonable efforts.

*Example 1*. (i) *Facts*. A plan sponsor distributes notice of a proposed suspension of benefits to plan participants, beneficiaries of deceased participants, and alternate payees by mailing the notice to their last known mailing addresses, using the same information that it used to send the most recent annual funding notice. Of 5,000 such notices, 300 were returned as undeliverable. The plan sponsor takes no additional steps to contact the individuals for whom the notice was returned as undeliverable.

(ii) *Conclusion*. The plan sponsor did not make any effort beyond the initial mailing to locate the 300 individuals for whom the notice was returned as undeliverable. Therefore, the plan sponsor did not satisfy the requirement to provide notice to all participants, beneficiaries of deceased participants, and alternate payees under the plan (regardless of whether their benefits are proposed to be suspended), except those who cannot be contacted by reasonable efforts.

*Example 2*. (i) *Facts*. The facts are the same as *Example 1*, but the plan sponsor contacts the bargaining parties for the plan and the plan administrators of any other employee benefit plans that the plan sponsor reasonably believes may have information useful for locating the missing individuals, and the plan sponsor requests contact information for the missing individuals. The plan sponsor then uses an Internet search tool, a credit reporting agency, and a commercial locator service to search for individuals for whom it was not able to obtain updated information from bargaining parties. Through these efforts, the plan sponsor locates the updated addresses of 250 of the 300 individuals whom it previously failed to contact. The plan sponsor mails notices to those individuals within one week of locating them.

(ii) *Conclusion*. By using effective search methods to find the previously missing individuals and promptly mailing the notice of suspension to them, the plan sponsor has satisfied the requirement to provide notice to all participants, beneficiaries of deceased participants, and alternate payees under the plan (regardless of whether their benefits are proposed to be suspended), except those who cannot be contacted by reasonable efforts.

(g) *Approval or denial of an application for suspension of benefits*—(1) *Application*—(i) *In general*. The plan sponsor of a plan in critical and declining status for a plan year that seeks to suspend benefits must submit an application for approval of the proposed suspension of benefits to the Secretary of the Treasury. The Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, will approve a complete application described in paragraph (g)(1)(ii) of this section upon finding that—

(A) The plan is eligible for the proposed suspension described in the application;

(B) The plan actuary and plan sponsor satisfy the requirements of section 432(e)(9)(C) in accordance with the rules of paragraph (c) of this section;

(C) The design of the proposed suspension described in the application satisfies the criteria of section 432(e)(9)(D) in accordance with the rules of paragraphs (d) of this section; and

(D) The plan sponsor satisfies the requirements of section 432(e)(9)(E) and (F) in accordance with the rules of paragraphs (e) and (f) of this section.

(ii) *Complete application*. After receiving a submission, the plan sponsor will be notified within two business days whether the submission constitutes a complete application. A complete application will be treated as submitted on the date that it was originally submitted to the Secretary of the Treasury. If a submission is incomplete, the notification will inform the plan sponsor of the information that is needed to complete the submission and give the plan sponsor a reasonable opportunity to submit a complete application. In such a case, the complete application will be treated as submitted on the date on which the additional information needed to complete the application is submitted to the Secretary of the Treasury.

(iii) *Submission of application*. An application described in this paragraph (g)(1) must be submitted electronically in a searchable format.

(iv) *Requirements for application*. Additional guidance that may be necessary or appropriate with respect to applications described in this paragraph (g)(1), including procedures for submitting applications and the information required to be included in a complete application, may be published in the form of revenue procedures, notices, or other guidance in the Internal Revenue Bulletin.

(v) *Requirement to provide adequate time to process application*—(A) *General rule*. An application for suspension that is not submitted in combination with an application to PBGC for a plan partition under section 4233 of ERISA generally will not be accepted unless the proposed effective date of the suspension is at least nine months from the date on which the application is submitted.

(B) *Earlier effective date in appropriate circumstances*. Nothwithstanding paragraph (g)(1)(v)(A) of this section, in appropriate circumstances the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, may permit a proposed suspension to have an earlier effective date.

(vi) *Plan sponsors that also apply for partition*. See part 4233 of the PBGC regulations for a coordinated application process that applies in the case of a plan sponsor that is submitting an application for suspension in combination with an application to PBGC for a plan partition under section 4233 of ERISA.

(2) *Solicitation of comments*—(i) *In general*. Not later than 30 days after receipt of a complete application described in paragraph (g)(1) of this section—

(A) The application for approval of the suspension of benefits will be published on the website of the Department of the Treasury; and

(B) The Secretary of the Treasury will publish a notice in the **Federal Register** soliciting comments from contributing employers, employee organizations, and participants and beneficiaries of the plan for which an application was made, and other interested parties.

(ii) *Public comments*. The notice described in paragraph (g)(2)(i)(B) of this section will generally request that comments be submitted no later than 45 days after publication of that notice in the **Federal Register**, but the notice may specify a different deadline for comments in appropriate circumstances. Comments received in response to this notice will be made publicly available.

(3) *Special rules in the case of revision to proposed suspension*—(i) *Resubmission review available in certain circumstances*. The Secretary of the Treasury (in consultation with PBGC and the Secretary of Labor) has the discretion, in appropriate circumstances, to permit the plan sponsor to submit a revision of a proposed suspension that had been withdrawn for resubmission review. With respect to an application that is accepted for resubmission review—

(A) The rules of paragraph (g)(1)(v)(B) of this section will apply;

(B) The limitations of paragraph (d) of this section with respect to the revised proposed suspension may be applied using the same actuarial data (including the same fair market value of the plan assets) as was used in the initial application;

(C) The revision to the proposed suspension will be published, and comments solicited, in accordance with paragraph (g)(2) of this section; and

(D) The plan sponsor must provide notice of the revised proposed suspension in accordance with the requirements of paragraph (g)(3)(ii) of this section.

(ii) *Requirement to provide updated notice to affected participants*—(A) *General rule*. Except as provided in paragraph (g)(3)(ii)(B) of this section, a plan sponsor that revises a proposed suspension in accordance with this paragraph (g)(3) must provide notice of the suspension in accordance with the rules of paragraph (f) of this section.

(B) *Treatment of participants who are not affected by the revision*. If the revision to the proposed suspension changes neither the amount of the suspension as initially proposed nor the effective date of the proposed suspension for an affected individual, then the Secretary of the Treasury (in consultation with PBGC and the Secretary of Labor) may permit the plan sponsor to provide a simplified version of the notice of the suspension to that individual. For this purpose, the effective date of a suspension is determined without taking into account the second sentence of paragraph (a)(4)(iii)(C) of this section.

(4) *Approval or denial*—(i) *Deemed approval*. A complete application described in paragraph (g)(1)(ii) of this section will be deemed approved unless, within 225 days following the date that the complete application is submitted, the Secretary of the Treasury notifies the plan sponsor that its application does not satisfy one or more of the requirements described in this paragraph (g).

(ii) *Notice of denial*. If the Secretary of the Treasury denies a plan sponsor's application, the notification of the denial will detail the specific reasons for the denial, including reference to the specific requirement not satisfied.

(iii) *Special rules for systemically important plans*. If the Secretary of the Treasury approves a plan sponsor's application and the Secretary expects that the plan is or may be a systemically important plan (as defined in paragraph (h)(5)(iv) of this section), the Secretary will so notify the plan sponsor. In that case, and in the event of a vote to reject the suspension (as described in paragraph (h)(4) of this section), the plan sponsor may be required to supply individual participant data and any actuarial analyses that the Secretary may request, in order to assist the Secretary in determining whether to permit the implementation of the suspension that was approved by the Secretary but rejected by a majority of the eligible voters or the implementation of a modification of that suspension.

(iv) *Agreement to stay 225-day period*. The Secretary of the Treasury and the plan sponsor may mutually agree in writing to stay the 225-day period described in paragraph (g)(3)(i) of this section.

(5) *Consideration of certain factors*. In evaluating whether the plan sponsor has satisfied the requirement of paragraph (c)(3)(i)(A) of this section, the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, will review the plan sponsor's consideration of each of the factors under paragraph (c)(3)(ii) of this section (and any other factor that the plan sponsor considered).

(6) *Standard for accepting plan sponsor determinations*. In evaluating the plan sponsor's application, the Secretary of the Treasury will accept the plan sponsor's determinations in paragraph (c)(3) of this section unless the Secretary concludes, in consultation with PBGC and the Secretary of Labor, that the determinations were clearly erroneous.

(7) *Plan sponsor certifications with respect to plan amendments*. The plan sponsor will not satisfy the requirements of paragraph (g)(1)(i)(B) and (D) of this section unless the plan sponsor certifies that if the plan sponsor receives final authorization to suspend as described in paragraph (h)(6) of this section with respect to the proposed benefit suspension (or, in the case of a systemically important plan, a proposed or modified benefit suspension), the plan sponsor chooses to implement the suspension, and the plan sponsor adopts the amendment described in paragraph (a)(1) of this section, then it will timely amend the plan to provide that—

(i) If the plan sponsor fails to make the annual determinations under section 432(e)(9)(C)(ii), then the suspension of benefits will cease as of the first day of the first plan year following the plan year in which the plan sponsor fails to make the annual plan sponsor determinations in paragraph (c)(4) of this section; and

(ii) Any future benefit improvement must satisfy the requirements of section 432(e)(9)(E).

(8) *Special Master*. The Secretary of the Treasury may appoint a Special Master for purposes of this section. If a Special Master is appointed, the Special Master will coordinate the implementation of this section and the review of applications for the suspension of benefits and other appropriate documents, and will provide recommendations to the Secretary of the Treasury with respect to decisions required under this section.

(h) *Participant vote on proposed benefit reduction*—(1) *Requirement for vote*—(i) *In general*. If an application for suspension is approved under paragraph (g) of this section, then the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, will administer a vote as described in section 432(e)(9)(H) and this paragraph (h). A suspension of benefits may not take effect before the vote and may only take effect after a final authorization to suspend benefits under paragraph (h)(6) of this section.

(ii) *Communication by plan sponsor*. The plan sponsor must take reasonable steps to inform eligible voters about the proposed suspension. This includes all eligible voters who may be contacted by reasonable efforts in accordance with paragraph (f)(1) of this section. Any eligible voter whom the plan sponsor has been able to locate through these means (or who has otherwise been located by the plan sponsor) must be—

(A) Included on the voting roster described in paragraph (h)(3)(iii)(B) of this section; and

(B) Sent a ballot described in paragraph (h)(3) of this section.

(iii) *Eligible voters*—(A) *General definition*. For purpose of this paragraph (h), the term "eligible voters" means all plan participants (that is, active plan participants, deferred vested participants, and retirees) and beneficiaries of deceased participants.

(B) *Voting roster*. The voting roster includes those eligible voters to whom the notices described in paragraph (f) of this section were sent. If there is a plan participant or beneficiary who did not receive a notice but who is subsequently located by the plan sponsor, that individual must be included on the roster. Similarly, if an individual becomes a plan participant after the date the notices were sent, then the individual must be included on the roster. If a plan sponsor learns after the date the notices described in paragraph (f) of this section were sent that an eligible voter has died, then that deceased individual must not be included on the roster (but if that participant has a beneficiary entitled to benefits under the plan, the beneficiary must be added to the roster).

(2) *Participant vote*—(i) *In general*. The participant vote described in paragraph (h)(1)(i) of this section requires completion of the following steps—

(A) Distribution of the ballot package described in paragraph (h)(2)(iii) of this section to the eligible voters;

(B) Voting by eligible voters and collection and tabulation of the votes, as described in paragraph (h)(2)(iv) of this section; and

(C) Determination of whether a majority of the eligible voters has voted to reject the suspension, as described in paragraph (h)(2)(v) of this section.

(ii) *Designation of service provider for limited functions*. The Secretary of the Treasury is permitted to designate one or more service providers to perform, under the supervision of the Secretary, any of the functions of the Secretary described in paragraphs (h)(2)(i)(A) and (B) of this section. If the Secretary designates a service provider to perform these functions then the service provider will provide the Secretary with a written report of the results of the vote, including (as applicable)—

(A) The number of ballot packages distributed to eligible voters;

(B) The number of eligible voters to whom ballot packages have not been provided (because the individuals could not be located);

(C) The number of eligible voters who voted (specifying the number of affirmative votes and the number of negative votes cast); and

(D) Any other information that the Secretary requires.

(iii) *Distribution of the ballot package to the eligible voters*—(A) *Ballot package*. The ballot package distributed to each eligible voter consists of—

(*1*) A ballot, approved under paragraph (h)(3)(iii) of this section, which contains the items described in section 432(e)(9)(H)(iii) and paragraph (h)(3)(i) of this section; and

(*2*) A voter identification code assigned to the eligible voter for use in voting.

(B) *Plan sponsor responsibilities*—(*1*) *In general*. This paragraph (h)(2)(iii)(B) sets forth the responsibilities of the plan sponsor with respect to the distribution of the ballot package to the eligible voters.

(*2*) *Furnish information regarding eligible voters*. No later than 7 days following the date the Secretary of the Treasury has approved an application for a suspension of benefits under paragraph (g) of this section, the plan sponsor must furnish the following—

(*i*) The voting roster described in paragraph (h)(1)(iii)(B) of this section;

(*ii*) Plan information (such as participant identification codes used by the plan) to enable the Secretary of the Treasury to verify the identity of each eligible voter;

(*iii*) For each eligible voter on the voting roster, the last known mailing address (or, if the plan sponsor has been unable to locate that individual using the standards that apply for purposes of paragraph (f)(1)(i) of this section, an indication that the individual could not be located through reasonable efforts);

(*iv*) Current electronic mailing addresses for those eligible voters identified in paragraph (h)(2)(iii)(B)(*4*) of this section; and

(*v*) The individualized estimates described in paragraph (f)(2)(i)(A) of this section (or, if an individualized estimate is no longer accurate for an eligible voter, a corrected version of that estimate).

(*3*) *Communication with eligible voters*. In accordance with section 432(e)(9)(H)(iv) and paragraph (h)(1)(ii) of this section, the plan sponsor is responsible for communicating with eligible voters, which includes—

(*i*) Notifying the eligible voters described in paragraph (h)(2)(iii)(B)(*4*) of this section that a ballot package will be mailed to them by first-class U.S. mail; and

(*ii*) Making reasonable efforts (using the standards that apply for purposes of paragraph (f)(1)(i) of this section) as necessary to locate eligible voters for whom the plan sponsor has received notification that the mailed ballot packages are returned as undeliverable (so that ballot packages can be sent to those eligible voters).

(*4*) *Eligible voters to receive electronic notification*. Those eligible voters whom the plan sponsor must notify electronically are—

(*i*) Eligible voters who previously received the notice described in paragraph (f) of this section in electronic form (as permitted under paragraph (f)(3)(ii) of this section), and

(*ii*) Any other eligible voters who regularly receive plan-related communications from the plan sponsor in electronic form.

(*5*) *Method of notifying certain eligible voters*. The notification described in paragraph (h)(2)(iii)(B)(*3*)(*i*) of this section for an eligible voter must be made using the electronic form normally used to send plan-related communications to that voter (or the form used to provide the notice in paragraph (f) of this section, if different). The plan sponsor must send this notification promptly after being informed of the ballot distribution date (within the meaning of paragraph (h)(2)(iii)(D) of this section) and the notification must include the ballot distribution date.

(*6*) *Pay costs associated with distribution*. The plan sponsor is responsible for paying all costs associated with printing, assembling, and distributing the ballot package, including postage.

(C) *Required method of distributing ballot package*. Ballot packages must be distributed to eligible voters by first-class U.S. mail. A supplemental copy of the mailed ballot package may also be sent by an electronic communication to an eligible voter who has consented to receive electronic communications.

(D) *Timing*. Ballot packages will be distributed to eligible voters no later than 30 days after the Secretary of the Treasury has approved an application for a suspension of benefits under paragraph (g) of this section. The date on which the ballot packages are mailed to the eligible voters is referred to as the ballot distribution date.

(iv) *Collection and tabulation of votes cast by eligible voters*—(A) *Voting period*. The voting period is the period during which a vote received from an eligible voter will be counted. The voting period begins on the ballot distribution date. The voting period generally remains open until the $30^{th}$ day following the date the Secretary of the Treasury has approved an application for a suspension of benefits under paragraph (g) of this section. However, the voting period will not close earlier than 21 days after the ballot distribution date. In addition, the Secretary (in consultation with PBGC and the Secretary of Labor) may specify a later date to end the voting period in appropriate circumstances.

(B) *Automated voting system must be provided*. An automated voting system that meets the requirements of paragraph (h)(2)(iv)(C) of this section must be made available to voters for casting their votes. In appropriate circumstances, the Secretary may, in consultation with PBGC and the Secretary of Labor, allow voters to cast votes by mail in lieu of using the automated voting system.

(C) *Automated voting system*. An automated voting system meets the requirements of this paragraph (h)(2)(iv)(C) only if the system—

(*1*) Collects votes cast by eligible voters both electronically (through a website) and telephonically (through a toll-free number allowing voters to cast their votes using both a touch-tone voting system and an interactive voice response system); and

(*2*) Accepts only votes cast during the voting period by an eligible voter who provides the eligible voter's identification code described in paragraph (h)(2)(iii)(A)(*2*) of this section.

(D) *Policies and procedures*. The Secretary of the Treasury (in consultation with PBGC and the Secretary of Labor) may establish such policies and procedures as may be necessary to facilitate the administration of the vote under this paragraph (h)(2). These policies and procedures may include, but are not limited to, establishing a process for an eligible voter to challenge the vote.

(v) *Determination of whether a majority of the eligible voters has voted to reject the suspension*. Within 7 calendar days after the end of the voting period, the Secretary of the Treasury (in consultation with PBGC and the Secretary of Labor) will—

(A) Certify that a majority of all eligible voters has voted to reject the suspension that was approved under paragraph (g) of this section, or

(B) Issue a final authorization to suspend as described in paragraph (h)(6) of this section.

(3) *Ballots*—(i) *In general*. The plan sponsor must provide a ballot for the vote that includes the following—

(A) A description of the proposed suspension and its effect, including the effect of the suspension on each category or group of individuals affected by the suspension and the extent to which they are affected;

(B) A description of the factors considered by the plan sponsor in designing the benefit suspension, including but not limited to the factors in paragraph (d)(6)(ii) of this section;

(C) A description of whether the suspension will remain in effect indefinitely or will expire by its own terms (and, if it will expire by its own terms, when that will occur);

(D) A statement from the plan sponsor in support of the proposed suspension;

(E) A statement in opposition to the proposed suspension compiled from comments received pursuant to the solicitation of comments pursuant to paragraph (g)(2) of this section;

(F) A statement that the proposed suspension has been approved by the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor;

(G) A statement that the plan sponsor has determined that the plan will become insolvent unless the proposed suspension takes effect (including the year in which insolvency is projected to occur without a suspension of benefits), and an accompanying statement that this determination is subject to uncertainty;

(H) A statement that insolvency of the plan could result in benefits lower than benefits paid under the proposed suspension and a description of the projected benefit payments in the event of plan insolvency;

(I) A statement that insolvency of PBGC would result in benefits lower than benefits otherwise paid in the case of plan insolvency;

(J) A statement that the plan's actuary has certified that the plan is projected to avoid insolvency, taking into account the proposed suspension of benefits (and, if applicable, a proposed partition of the plan), and an accompanying statement that the actuary's projection is subject to uncertainty;

(K) A statement that the suspension will go into effect unless a majority of all eligible voters vote to reject the suspension and that, therefore, a failure to vote has the same effect on the outcome of the vote as a vote in favor of the suspension;

(L) A copy of the individualized estimate described in paragraph (f)(2)(i)(A) of this section (or, if that individualized estimate is no longer accurate, a corrected version of that estimate); and

(M) A description of the voting procedures, including the deadline for voting.

(ii) *Additional rules*—(A) *Readability requirement*. A ballot provided under section 432(e)(9)(H)(iii), in accordance with the rules of paragraph (h)(3)(i) of this section, must be written in a manner that is readily understandable by the average plan participant.

(B) *No false or misleading information*. A ballot provided under section 432(e)(9)(H)(iii), in accordance with the rules of paragraph (h)(3)(i) of this section, may not include false or misleading information (or omit information in a manner that causes the information provided to be misleading).

(iii) *Ballot must be approved*. Any ballot provided under section 432(e)(9)(H)(iii), in accordance with the rules of paragraph (h)(3)(i) of this section, must be approved by the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, before it is provided.

(iv) *Statement in opposition to the proposed suspension*. The statement in opposition to the proposed suspension that is prepared from comments received on the application, as required under section 432(e)(9)(H)(iii)(II), will be compiled by the Secretary of Labor and will be written in accordance with the rules of paragraph (h)(3)(ii) of this section. If no comments in opposition are received, the statement in opposition to the proposed suspension will include a statement indicating that there were no such comments.

(v) *Model ballot*. Model language for use in the ballot may be published in the Internal Revenue Bulletin.

(4) *Implementing suspension following vote*—(i) *In general*. Unless a majority of all eligible voters vote to reject the suspension that was approved under paragraph (g) of this section, the suspension will be permitted to take effect. If a majority of all eligible voters vote to reject the suspension that was approved under paragraph (g) of this section, a suspension of benefits will not be permitted to take effect except as provided under paragraph (h)(5)(iii) of this section relating to the implementation of a suspension for a systemically important plan (as defined in paragraph (h)(5)(iv) of this section).

(ii) *Effect of not sending ballot*. Any eligible voters to whom ballots have not been provided (because the individuals could not be located) will be treated as voting to reject the suspension at the same rate (in other words, in the same percentage) as those to whom ballots have been provided.

(5) *Systemically important plans*—(i) *In general*. If a majority of all eligible voters vote to reject the suspension that was approved under paragraph (g) of this section, the Secretary of the Treasury will consult with PBGC and the Secretary of Labor to determine if the plan is a systemically important plan. This determination will be made no later than 14 days after the results of the vote are certified.

(ii) *Recommendations from Participant and Plan Sponsor Advocate*. If the plan is determined to be a systemically important plan, then, no later than 44 days after the results of the vote are certified, the Participant and Plan Sponsor Advocate selected under section 4004 of ERISA may submit recommendations to the Secretary of the Treasury with respect to the suspension that was approved under paragraph (g) of this section or any modifications to the suspension.

(iii) *Implementation of original or modified suspension by systemically important plans*. If a plan is a systemically important plan for which a majority of all eligible voters vote to reject the suspension that was approved under paragraph (g) of this section, then the Secretary of the Treasury must determine whether to permit the implementation of the suspension that was approved under paragraph (g) of this section or whether to permit the implementation of a modification of that suspension. Under any such modification, the plan must be projected to avoid insolvency in accordance with section 432(e)(9)(D)(iv). No later than 60 days after the results of a vote to reject a suspension are certified, the Secretary of the Treasury will notify the plan sponsor that the suspension or modified suspension is permitted to be implemented.

(iv) *Systemically important plan defined*—(A) *In general*. For purposes of this paragraph (h)(5), a systemically important plan is a plan with respect to which PBGC projects that the present value of its financial assistance payments will exceed \$1.0 billion (adjusted in accordance with paragraph (h)(5)(iv)(B) of this section to the calendar year in which the application is submitted) if the suspension is not implemented.

(B) *Indexing*. For calendar years beginning after 2015, the dollar amount specified in paragraph (h)(5)(iv)(A) of this section will be replaced with an amount equal to the product of the dollar amount and a fraction, the numerator of which is the contribution and benefit base (determined under section 230 of the Social Security Act) for the preceding calendar year and the denominator of which is the contribution and benefit base for calendar year 2014. If the amount otherwise determined under this paragraph (h)(5)(iv)(B) is not a multiple of $1.0 million, the amount will be rounded to the next lowest multiple of $1.0 million.

(6) *Final authorization to suspend*—(i) *In general*. In any case in which a suspension is permitted to take effect following a vote pursuant to section 432(e)(9)(H)(ii) and paragraph (h)(4) of this section, the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, will issue a final authorization to suspend with respect to the suspension not later than seven days after the vote.

(ii) *Systemically important plans*. In any case in which a suspension is permitted to take effect following a determination under paragraph (h)(5) of this section that the plan is a systemically important plan, the Secretary of the Treasury, in consultation with PBGC and the Secretary of Labor, will issue a final authorization to suspend, at a time sufficient to allow the implementation of the suspension prior to the end of the 90-day period beginning on the date the results of the vote are certified.

(iii) *Plan partitions*. Notwithstanding any other provision of this section, in any case in which a suspension of benefits with respect to a plan is made in combination with a partition of the plan, the suspension of benefits is not permitted to take effect prior to the effective date of the partition.

(i) [Reserved].

(j) *Effective/applicability date*. This section applies with respect to suspensions for which the approval or denial is issued on or after April 26, 2016 and, in the case of a systemically important plan, any modification described in paragraph (h)(5)(iii) of this section that is implemented on or after April 26, 2016.

**Section 1.432(e)(9)–1T [Removed]**

Par. 3. Section 1.432(e)(9)–1T is removed.

John Dalrymple,
*Deputy Commissioner for Services and Enforcement.*

Approved: April 21, 2016.

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

(Filed by the Office of the Federal Register on April 27, 2016, 8:45 a.m., and published in the issue of the Federal Register for April 28, 2016, 81 F.R. 25328)

# Part III. Administrative, Procedural, and Miscellaneous

*26 CFR 601.602: Tax forms and instructions.*
*(Also: Part 1, §§ 1, 223)*

## Rev. Proc. 2016–28

### SECTION 1. PURPOSE

This revenue procedure provides the 2017 inflation adjusted amounts for Health Savings Accounts (HSAs) as determined under § 223 of the Internal Revenue Code.

### SECTION 2. 2017 INFLATION ADJUSTED ITEMS

*Annual contribution limitation*. For calendar year 2017, the annual limitation on deductions under § 223(b)(2)(A) for an individual with self-only coverage under a high deductible health plan is $3,400. For calendar year 2017, the annual limitation on deductions under § 223(b)(2)(B) for an individual with family coverage under a high deductible health plan is $6,750.

*High deductible health plan*. For calendar year 2017, a "high deductible health plan" is defined under § 223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,300 for self-only coverage or $2,600 for family coverage, and the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $6,550 for self-only coverage or $13,100 for family coverage.

### SECTION 3. EFFECTIVE DATE

This revenue procedure is effective for calendar year 2017.

### SECTION 4. DRAFTING INFORMATION

The principal author of this revenue procedure is Bill Ruane of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding § 223 and HSAs, contact Karen Levin at (202) 317-5500 (not a toll-free number). For further information regarding the calculation of the inflation adjustments in this revenue procedure, contact Mr. Ruane at (202) 317-4718 (not a toll-free number).

# Part IV. Items of General Interest

## Limited Penalty Relief for Filers of Form 1098–T, *Tuition Statement*

### Announcement 2016–17

This announcement provides notice that the IRS will not impose penalties under section 6721 or 6722 on eligible educational institutions with respect to Forms 1098–T, *Tuition Statement*, required to be filed and furnished for the 2016 calendar year under section 6050S if the institution reports the aggregate amount billed for qualified tuition and related expenses on Form 1098–T instead of the aggregate amount of payments received as required by section 212 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114–113 (129 Stat. 2242 (2015))(PATH). The penalty relief in this announcement is limited to 2016 Forms 1098–T required to be filed by eligible educational institutions by February 28, 2017 (or March 31, 2017, if filed electronically), and furnished to recipients by January 31, 2017. This announcement does not provide penalty relief for any other failure that would cause a filer to be subject to penalties under section 6721 or 6722, or any other penalty under any provision of the Code.

Sections 6050S(a)(1) and 6050S(d) generally require eligible educational institutions to file information returns with the IRS and to furnish written statements to individuals relating to qualified tuition and related expenses paid by, or on behalf of, students. Section 6050S(b)(2) specifies the contents of the information return and, effective for expenses paid after December 31, 2015, requires eligible educational institutions to report the aggregate amount of payments received for qualified tuition and related expenses during the calendar year from, or on behalf of, a student. Previously, section 6050S(b)(2) allowed eligible educational institutions to report either the aggregate amount of payments received for qualified tuition and related expenses or the aggregate amount billed for such tuition and expenses. Section 1.6050S–1(b)(5) provides that information returns required under section 6050S must be filed by February 28 (or March 31 if filed electronically) of the year following the calendar year to which such returns relate. Section 6050S(d) provides that written statements required under that section must be furnished to recipients by January 31 of the year following the calendar year for which such statements are furnished.

Section 212 of PATH amended section 6050S(b)(2) and eliminated the option for eligible educational institutions to report aggregate qualified tuition and related expenses billed for the calendar year. This amendment is effective for qualified tuition and related expenses paid after December 31, 2015, for education furnished in academic periods beginning after such date.

Section 6721 imposes a penalty for failure to file correct or timely information returns with the IRS. Section 6722 imposes a penalty for failure to furnish a correct or timely written statement to the recipient. These penalties do not apply if it is shown under section 6724 that the failure is due to reasonable cause and not due to willful neglect.

Form 1098–T is the information return for purposes of satisfying the reporting obligations described in sections 6050S(a)(1) and 6050S(d). Prior to enactment of section 212 of PATH, eligible educational institutions reported qualified tuition and related expenses on Form 1098–T either as payments received for the calendar year in Box 1 of the form or as amounts billed during a calendar year in Box 2 of the form.

Following the enactment of PATH, numerous eligible educational institutions informed the IRS that implementation of the law change will require computer software reprogramming and other changes that cannot be implemented in time to meet the applicable filing and furnishing due dates for Form 1098–T for calendar year 2016.

In light of this, the IRS will not impose penalties under section 6721 or 6722 with respect to 2016 Forms 1098–T solely because the eligible educational institution reports the aggregate amount billed for qualified tuition and related expenses for the 2016 calendar year. Thus, eligible educational institutions will continue to have the option of reporting either the amount of payments of qualified tuition and related expenses received or the amount of qualified tuition and related expenses billed for the 2016 calendar year without being subject to penalties. Institutions should refer to the instructions for the 2016 Form 1098–T for further guidance for reporting of these amounts. This penalty relief does not apply to any other failure subject to a penalty under section 6721 or 6722.

The principal author of this announcement is Gerald Semasek of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this announcement, contact Gerald Semasek at (202) 317-6845 (not a toll-free number).

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## Partial Withdrawal of Notice of Proposed Rulemaking

## Partial Withdrawal of Proposed Application of Section 367 to a Section 351 Exchange Resulting From a Transaction Described in Section 304(a)(1); Partial Withdrawal of Proposed Guidance for Determining Stock Ownership

### REG–135734–14

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws portions of a notice of proposed rulemaking published in the **Federal Register** on February 11, 2009. The withdrawn portions relate to the application of section 367(b) to transactions described in section 304(a)(1). This document also withdraws portions of a notice of proposed rulemaking published in the **Federal Register** on January 17, 2014. The withdrawn portions relate to the identification of certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation for purposes of section 7874.

DATES: As of April 8, 2016, portions of proposed rules (REG–147636–08 and REG–121534–12) published in the **Federal Register** on February 11, 2009 (74 FR 6840) and January 17, 2014 (79 FR 3145) are withdrawn.

FOR FURTHER INFORMATION CONTACT: Shane M. McCarrick or David A. Levine, (202) 317-6937.

SUPPLEMENTARY INFORMATION:

**Background**

On February 11, 2009, the Department of Treasury (Treasury Department) and the IRS published in the **Federal Register** proposed regulations (REG–147636–08, 74 FR 6840), including § 1.367(b)–4(e), (f), and (g), which provide guidance on the application of section 367(b) to transactions described in section 304(a)(1). The regulations were proposed by cross-reference to temporary regulations in § 1.367(b)–4T in the same issue of the **Bulletin** (T.D. 9444, 74 FR 6824). This document withdraws these proposed regulations because the rules in the proposed regulations do not reflect current law. See Notice 2012–15, 2012–9 I.R.B. 424 (revising the approach under the proposed regulations regarding the interaction of sections 367 and 304 and providing that section 367(a) and (b) apply fully to certain transctions described in section 304(a)(1)). In this issue of the **Bulletin**, the Treasury Department and the IRS are issuing additional temporary regulations in § 1.367(b)–4T(e), (f), and (g), as well as (h), that, in the case of certain exchanges, generally require an inclusion of amounts in income as a deemed dividend or recognition of realized gain that is not otherwise recognized, or both. Accordingly, the Treasury Department and the IRS issued a notice of proposed rulemaking in the 2016–18 issue of the **Bulletin** that proposes new rules in § 1.367(b)–4T by cross-reference to the temporary regulations.

On January 17, 2014, the Treasury Department and the IRS published in the **Federal Register** proposed regulations (REG–121534–12, 79 FR 3145), including in § 1.7874–4, that provide that certain stock of a foreign corporation is disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation for purposes of section 7874. The regulations were proposed by cross-reference to temporary regulations in § 1.7874–4T in the same issue of the **Bulletin** (T.D. 9654, 79 FR 3094). In this issue of the **Bulletin**, the Treasury Department and the IRS are amending certain of the temporary regulations in § 1.7874–4T. Accordingly, the Treasury Department and the IRS issued a notice of proposed rulemaking in the 2016–18 issue of the **Bulletin** that proposes rules in § 1.7874–4 by cross-reference to the amended temporary regulations. This document withdraws the previously proposed regulations that are replaced by the notice of proposed rulemaking in the 2016–18 issue of the **Bulletin**.

* * * * *

**Partial Withdrawal of a Notice of Proposed Rulemaking**

Accordingly, under the authority of 26 U.S.C. 7805, § 1.367(b)–4(e), (f), and (g) of the notice of proposed rulemaking (REG–147636–08) published in the **Federal Register** on February 11, 2009 (74 FR 6840) are withdrawn. Also, under the authority of 26 U.S.C. 7805, § 1.7874–4(c)(1)(i), (c)(1)(ii)(B), (c)(2), (d)(1)(i), (d)(1)(ii), (h), (i)(6), (i)(7)(iii)(C), (i)(7)(iv), (j)(7), (j)(8), and (k)(1), as well as paragraph (ii) of

*Example 1*, paragraph (ii) of *Example 2*, and *Example 3* through *Example 8* of § 1.7874–4(j), of the notice of proposed rulemaking (REG–121534–12) published in the **Federal Register** on January 17, 2014 (79 FR 3145) are withdrawn.

John Dalrymple,
*Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on April 4, 2016, 5:00 p.m., and published in the issue of the Federal Register for April 8, 2016, 81 F.R. 20587)

# 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.

## Numerical Finding List[1]

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### Revenue Rulings:



### Treasury Decisions:



[1]A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2015–27 through 2015–52 is in Internal Revenue Bulletin 2015–52, dated December 28, 2015.

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[1]A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2015–27 through 2015–52 is in Internal Revenue Bulletin 2015–52, dated December 28, 2015.

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# 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/*.

# We Welcome Comments About the Internal Revenue Bulletin

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page (*www.irs.gov*) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.