Internal Revenue
bulletin

Bulletin No. 1998–41
October 13, 1998

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 8782, page 5.
Final regulations under section 927 of the Code provide guidance to taxpayers who have made an election to be treated as a foreign sales corporation (FSC).

T.D. 8783, page 4.
Final regulations under section 368 of the Code that provide guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations are amended.

EMPLOYMENT TAX

REG–209769–95, page 8.
Proposed regulations under section 3221 of the Code provide guidance to employers covered by the Railroad Retirement Tax Act. A public hearing will be held on January 20, 1999.

ADMINISTRATIVE

REG–106221–98, page 10.
Proposed regulations under section 1032 of the Code relate to the treatment of a disposition by a corporation of the stock of another corporation in a taxable transaction. A public hearing will be held on January 7, 1999.

Announcement 98–88, page 14.
The Service announces that 1998 is not a cut-off year for the Medical Savings Account pilot project.

Announcement 98–92, page 15.
The July 1998 revision of the Instructions for Form 706 is corrected.

Finding Lists begin on page 20.
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Department of the Treasury
Internal Revenue Service

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

T.D. 8783

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Continuity of Interest Requirement for Corporate Reorganizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Amendment to final regulations.

SUMMARY: This document amends final regulations providing guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. The amendment to the final regulations affects corporations and their shareholders. This amendment to the final regulations is necessary to provide clarification regarding an example illustrating a relationship created in connection with a potential reorganization.

DATES: *Effective date:* This amendment is effective September 23, 1998.

Applicability date: This amendment applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

FOR FURTHER INFORMATION CONTACT: Phoebe Bennett, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 28, 1998, the IRS published final regulations (REG–252231–96) in the **Federal Register** (63 F.R. 4174) relating to the continuity of interest (COI) requirement.

Explanation of Provisions

The final COI regulation provides that acquisitions of target (T) stock for cash by a corporation related to the issuing corporation (P) generally do not preserve continuity of interest. See §1.368–1(e)(2). Two corporations are related if they are members of the same affiliated group as defined in section 1504, or if a purchase of P stock by another corporation would be treated as a distribution in redemption of P stock under section 304(a)(2). See §1.368–1(e)(3). A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of T stock, or if the relationship is created in connection with the potential reorganization. See §1.368–1(e)(3)(ii). Thus, a purchase by a corporation that was not initially related to P, but purchased T stock and became related to P in the potential reorganization, would not preserve continuity to the extent of the purchase.

Section 1.368–1(e)(6), *Example 2* was intended to illustrate this principle. In the example, A owns all of the stock of T. X, a corporation which owns 60 percent of the P stock and none of the T stock, buys A's T stock for cash prior to the merger of T into P. X exchanges the T stock for P stock in the merger which, when combined with X's prior ownership of P stock, constitutes 80 percent of the stock of P. The example shows that X is related to P because X becomes affiliated with P in the merger.

Section 1.338–2(c)(3) provides that, by virtue of section 338, COI is satisfied for certain persons if, following a qualified stock purchase (QSP) of T by the purchasing corporation, the purchasing corporation or a member of the purchasing corporation's affiliated group acquired the T assets. Commentators have questioned whether §1.338–2(c)(3) applies to the transaction described in *Example 2*. It is not intended that these final regulations provide guidance under section 338. To avoid any such implication, *Example 2* is amended so that X's acquisition of A's T stock is not a QSP.

In addition, the amendment to the final regulation illustrates the proper application of the related party rule that treats two corporations as related if a purchase of P stock by another corporation would be treated as a distribution in redemption of P stock under section 304(a)(2). See §1.368–1(e)(3)(i). Commentators have questioned why, in *Example 2*, X is not already related to P under the section 304(a)(2) rule even before the merger, because X owned more than 50 percent of the P stock. Section 304(a)(2) requires that the issuing corporation control the acquiring corporation (within the meaning of section 304(c)). In *Example 2*, P is the issuing corporation and X is the acquiring corporation. X is not related to P under section 304(a)(2) because P does not control X; instead, X controls P. A sentence is added to *Example 2* to illustrate this point.

Applicability Date

The amendment to these final regulations applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

Special Analyses

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

Drafting Information

The principal author of this amendment to the final regulations is Phoebe Bennett of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other per-

sonnel from the IRS and Treasury Department participated in its development.

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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 continues to read in part as follows:

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

Par. 2. In §1.368–1, paragraph (e)(6) Example 2 is revised to read as follows:

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

* * * * *

(e) * * *

(6) * * *

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A's T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X's ownership interest in P increases from 60 to 80 percent of the stock of P. X is not a person related to P under paragraph (e)(3)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(3)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

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Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved September 14, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 22, 1998, 8:45 a.m., and published in the issue of the Federal Register for September 23, 1998, 63 F.R. 50757)

Section 927.—Other Definitions and Special Rules

26 CFR 1.927(e)–1: Special sourcing rule.

T.D. 8782

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Source Rules for Foreign Sales Corporation Transfer Pricing

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance to taxpayers who have made an election to be treated as a foreign sales corporation (FSC). The regulations clarify that the special source rule under section 927(e)(1) applies only to income of related suppliers from sales of export property giving rise to foreign trading gross receipts of a FSC.

DATES: *Effective date.* These regulations are effective March 3, 1998.

Applicability date. These regulations apply to taxable years beginning after December 31, 1997.

FOR FURTHER INFORMATION CONTACT: Elizabeth Beck (202) 874-1490 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 927 which was added by the Deficit Reduction Act of 1984, applicable for taxable years of foreign sales corporations beginning after December 31, 1984. Temporary regulations (T.D. 8126) were published in the **Federal Register** (52 F.R. 6468 [1987–1 C.B. 184]) on March 3, 1987. These temporary regulations were amended by temporary regulations published in the **Federal Register** (63 F.R. 10305) as a Treasury decision (T.D. 8764 [1998–15 I.R.B. *9*]) on March 3, 1998. On the same date, a notice of proposed rulemaking cross-referencing TD 8764 was published in the **Federal Register** (63 F.R. 10351 [REG–102144–98, 1998–15 I.R.B. 25]). The proposed rule proposed changes to the grouping and source rules for foreign sales corporation transfer pricing. Comments responding to this notice were received. On June 24, 1998, a public hearing was held limited to the proposed changes to the grouping rules, since no hearing was requested with respect to the source rule. After consideration of all comments received, the proposed regulations regarding the source rule are adopted as revised by this Treasury decision.

Explanation of Provisions

A. *Current Temporary Regulations.*

Section 927(e)(1) provides that "under regulations, the income of a person described in section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under section 994 which corresponds to the rule used under section 925 with respect to such transaction applied to such transaction." Transactions giving rise to foreign trading gross receipts include qualifying sales, leases, licenses and services. Because T.D. 8126 could be interpreted to apply the special foreign source limit only to sales of export property, §1.927(e)–1T was amended by T.D. 8764 to clarify that the regulation applies to any transaction giving rise to foreign trading gross receipts of a FSC, including but not limited to sales, leases, licenses and services. T.D. 8764 also made conforming changes, added special rules and gave examples regarding the special source rule.

B. *Discussion of Comments*

No comments were received on the special rules added in proposed §1.927(e)–1(a)(3)(ii). These rules clarify how the corresponding DISC transfer pricing rules are to be applied for purposes of the foreign source limit and are generally taxpayer favorable. No comments were received on Examples (1) and (3) set forth in proposed §1.927(e)–1(b).

These examples illustrate how the limit is applied under different transfer pricing methods for sales transactions.

Comments received did suggest that the rule distinguish between the foreign source income limitation applicable to sales and the limitation applicable to other transactions giving rise to foreign trading gross receipts. In light of these comments, Treasury and the IRS believe that additional consideration shouldbe given to the appropriate scope of the special source rule of section 927(e)(1) and that the expanded special source rule should be withdrawn. Accordingly, the final regulation applies the special source rule only to sales of export property. Example (2) of the proposed regulation, which addressed a licensing transaction, has been removed.

Special Analyses

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

Drafting Information

The principal author of these regulations is Elizabeth Beck of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in the development of these regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part l is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.927(e)–1T and adding an entry in numerical order to read as follows:

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

Section 1.927(e)–1 also issued under 26 U.S.C. 927(e)(1). * * *

§1.927(e)–1T [Removed]

Par. 2. Section 1.927(e)–1T is removed.

Par. 3. Section 1.927(e)–1 is added to read as follows:

§1.927(e)–1 Special sourcing rule.

(a) *Source rules for related persons*—(1) *In general.* The income of a person described in section 482 from a sale of export property giving rise to foreign trading gross receipts of a FSC that is treated as from sources outside the United States shall not exceed the amount that would be treated as foreign source income earned by such person if the pricing rule under section 994 that corresponds to the rule used under section 925 with respect to such transaction applied to such transaction. This special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier with respect to the transaction described in the first sentence of this paragraph (a)(1) that gives rise to foreign trading gross receipts and the transfer pricing rules of section 925 are used to determine the commission payable to the FSC. No limitation results under this section with respect to a transaction to which the section 482 pricing rule under section 925(a)(3) applies.

(2) *Grouping of transactions.* If, for purposes of determining the FSC's profits under the administrative pricing rules of sections 925(a)(1) and (2), grouping of transactions under §1.925(a)–1T(c)(8) was elected, the same grouping shall be used for making the determinations under the special sourcing rule in this section.

(3) *Corresponding DISC pricing rules*—(i) *In general.* For purposes of this section—

(A) The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1);

(B) The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2); and

(C) The DISC section 482 pricing rule of section 994(a)(3) corresponds to the section 482 pricing rule of section 925(a)(3).

(ii) *Special rules.* For purposes of this section—

(A) The DISC pricing rules of section 994(a)(1) and (2) shall be determined without regard to export promotion expenses;

(B) Qualified export receipts under section 994(a)(1) and (2) shall be deemed to be an amount equal to the foreign trading gross receipts arising from the transaction; and

(C) Combined taxable income for purposes of section 994(a)(2) shall be deemed to be an amount equal to the combined taxable income for purposes of section 925(a)(2) arising from the transaction.

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

Example 1. (i) R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is a FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is $100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

(ii) Under section 925(a)(2), 23 percent of the $100 combined taxable income of R and F ($23) is allocated to F and the remaining $77 is allocated to R. Absent the special sourcing rule, under section 863(b) the $77 income allocated to R would be sourced $38.50 U.S. source and $38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), $50 of the combined taxable income ($100 × .50) would be allocated to the DISC and the remaining $50 would be allocated to the related supplier. Under section 863(b), the $50 income allocated to the DISC's related supplier would be sourced $25 U.S. source and $25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $25.

Example 2. (i) Assume the same facts as in *Example 1* except that R and F used the gross receipts pricing rule of section 925(a)(1). In addition, for the taxable year foreign trading gross receipts derived from the sale of the export property are $2,000.

(ii) Under section 925(a)(1), 1.83 percent of the $2,000 foreign trading gross receipts ($36.60) is allocated to F and the $63.40 remaining combined taxable income ($100 – $36.60) is allocated to R. Absent the special sourcing rule, under section 863(b) the $63.40 income allocated to R would be sourced $31.70 U.S. source and $31.70 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1). Under section 994(a)(1), $80 ($2,000 × .04) would be allocated to the DISC and the $20 remaining combined taxable income would be allocated to the related supplier. Under section 863(b), the $20 income allocated to the DISC's related supplier would be sourced $10 U.S. source and $10 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $10.

(c) *Effective date.* The rules of this section are applicable to taxable years beginning after December 31, 1997.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved August 18, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 17, 1998, 8:45 a.m., and published in the issue of the Federal Register for September 21, 1998, 63 F.R. 50143)

Part IV. Items of General Interest

Notice of Rulemaking and Notice of Public Hearing

Exception From Supplemental Annuity Tax on Railroad Employers

REG–209769–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide guidance to employers covered by the Railroad Retirement Tax Act. The Railroad Retirement Tax Act imposes a supplemental tax on those employers, at a rate determined by the Railroad Retirement Board, to fund the Railroad Retirement Board's supplemental annuity benefit. These proposed regulations provide rules for applying the exception from the supplemental tax with respect to employees covered by a supplemental pension plan established pursuant to a collective bargaining agreement and for applying a related excise tax with respect to employees for whom the exception applies. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by December 22, 1998. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for January 20, 1999, must be received by December 30, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209769–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–209769–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Linda S. F. Marshall, (202) 622-6030; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Employment Tax Regulations (26 CFR Part 31) under section 3221(d). These proposed regulations provide guidance regarding the section 3221(d) exception from the tax imposed under section 3221(c) with respect to employees covered by a supplemental pension plan of the employer established pursuant to an agreement reached through collective bargaining.

Under the Railroad Retirement Act of 1974, as amended (RRA), an employee of a railroad employer generally is entitled to receive a supplemental annuity paid by the Railroad Retirement Board (RRB) at retirement. An employee is entitled to receive a supplemental annuity only if the employee has performed at least 25 years of service with the railroad industry, including service with the railroad industry before October 1, 1981. The monthly amount of the supplemental annuity ranges from $23 to $43, based on the employee's number of years of service. See 45 U.S.C. 231b(e). Under section 2(h)(2) of the RRA, an employee's supplemental annuity is reduced by the amount of payments received by the employee from any plan determined by the RRB to be a supplemental pension plan of the employer, to the extent those payments are derived from employer contributions.

Section 3221(c) imposes a tax on each railroad employer to fund the supplemental annuity benefits payable by the Railroad Retirement Board. The tax imposed under section 3221(c) is based on workhours for which compensation is paid. The rate of tax under section 3221(c) is established by the RRB quarterly, and is calculated to generate sufficient tax revenue to fund the RRB's current supplemental annuity obligations.

Under section 3221(d), the tax imposed by section 3221(c) does not apply to an employer with respect to employees who are covered by a supplemental pension plan established pursuant to an agreement reached through collective bargaining between the employer and employees. However, if an employee for whom the employer is relieved of any tax under the section 3221(d) exception becomes entitled to a supplemental annuity from the RRB, the employer is subject to an excise tax equal to the amount of the supplemental annuity paid to the employee (plus a percentage determined by the RRB to be sufficient to cover administrative costs attributable to those supplemental annuity payments).

Section 3221(d) was enacted by Public Law 91–215, 84 Stat. 70, which amended the Railroad Retirement Act of 1937 and the Railroad Retirement Tax Act. The legislative history to Public Law 91–215 indicates that the exception under section 3221(d) from the tax imposed under section 3221(c) was "directed primarily at the situation existing on certain short-line railroads which are owned by the steel companies. The employees of these lines are, for the most part, covered by other supplemental pension plans established pursuant to collective bargaining agreements between the steel companies and the unions representing the majority of their employees. . . . [T]hese railroads will no longer be required to pay a tax to finance the supplemental annuity fund, but will be required to reimburse the Railroad Retirement Board for any supplemental annuities that their employees may be paid upon retirement." S. Rep. 91–650, 91st Cong., 2d Sess. 6 (February 3, 1970).

Summary of Regulations

These proposed regulations provide rules for determining whether a plan is a supplemental pension plan established pursuant to an agreement reached through collective bargaining. Under these proposed regulations, a plan is a supplemental pension plan only if the plan is a pen-

sion plan within the meaning of §1.401–1(b)(1)(i). Under this definition, a plan is a pension plan only if the plan is established and maintained primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. Thus, for example, a plan generally is not a supplemental pension plan if distributions from the plan that are attributable to employer contributions may be made prior to a participant's death, disability, or termination of employment. See Rev. Rul. 74–254 (1974–1 C.B. 90); Rev. Rul. 56–693 (1956–2 C.B. 282).

These proposed regulations also require that the RRB determine that a plan is a private pension under its regulations in order for the plan to be a supplemental pension plan under section 3221(d) and these proposed regulations. This requirement is included because the section 3221(d) exception to the section 3221(c) tax is based on the assumption that any participant for whom the exception applies will receive a reduced supplemental annuity because of the supplemental pension plan on account of which the section 3221(c) tax is eliminated.

The IRS requests comments regarding other appropriate requirements for a supplemental pension plan within the meaning of section 3221(d).

These proposed regulations also provide rules for determining whether a plan is established by collective bargaining agreement with respect to an employer. These rules generally follow the rules applicable to qualified plans for this purpose.

Section 3221(d) imposes an excise tax equal to the amount of the supplemental annuity paid to any employee with respect to whom the employer has been excepted from the section 3221(c) tax under the section 3221(d) exception. These proposed regulations include rules applying this excise tax under section 3221(d).

Proposed Effective Date

These proposed regulations are proposed to be effective October 1, 1998.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 20, 1999, at 10 a.m. in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments and an outline of topics to be discussed and the time to be devoted to each topic (in the manner described under the ADDRESSES caption of this preamble) by December 30, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Linda S. F. Marshall, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME AT SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Par. 2. Section 31.3221–4 is added under the undesignated center heading "Tax on Employers" to read as follows:

§31.3221–4 Exception from supplemental tax.

(a) *General rule.* Section 3221(d) provides an exception from the excise tax imposed by section 3221(c). Under this exception, the excise tax imposed by section 3221(c) does not apply to an employer with respect to employees who are covered by a supplemental pension plan, as defined in paragraph (b) of this section, that is established pursuant to an agreement reached through collective bargaining between the employer and employees, within the meaning of paragraph (c) of this section.

(b) *Definition of supplemental pension plan*—(1) *In general.* A plan is a supplemental pension plan covered by the section 3221(d) exception described in paragraph (a) of this section only if it meets the requirements of paragraphs (b)(2) through (4) of this section.

(2) Pension benefit requirement. A plan is a supplemental pension plan within the meaning of this paragraph (b) only if the plan is a pension plan within the meaning of §1.401–1(b)(1)(i) of this chapter. Thus, a plan is a supplemental pension plan only if the plan provides for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. A plan need not be funded through a qualified trust that meets the requirements of section 401(a) or an annuity contract that meets the requirements of section 403(a) in order to meet the requirements of this paragraph (b)(2). A plan that is a profit-sharing plan within the meaning of §1.401–1(b)(1)(ii) of this chapter or a stock bonus plan within the meaning of

§1.401–1(b)(1)(iii) of this chapter is not a supplemental pension plan within the meaning of this paragraph (b).

(3) *Railroad Retirement Board determination with respect to the plan.* A plan is a supplemental pension plan within the meaning of this paragraph (b) with respect to an employee only during any period for which the Railroad Retirement Board has made a determination under 20 CFR 216.42(d) that the plan is a private pension, the payments from which will result in a reduction in the employee's supplemental annuity payable under 45 U.S.C. 231a(b). A plan is not a supplemental pension plan for any time period before the Railroad Retirement Board has made such a determination, or after that determination is no longer in force.

(4) *Other requirements.* [Reserved]

(c) *Collective bargaining agreement.* A plan is established pursuant to a collective bargaining agreement with respect to an employee only if, in accordance with the rules of §1.410(b)–6(d)(2) of this chapter, the employee is included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, provided that there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers.

(d) *Substitute section 3221(d) excise tax.* Section 3221(d) imposes an excise tax on any employer who has been excepted from the excise tax imposed under section 3221(c) by the application of section 3221(d) and paragraph (a) of this section with respect to an employee. The excise tax is equal to the amount of the supplemental annuity paid to that employee under section 2(b) of the Railroad Retirement Act of 1974 (88 Stat. 1305), plus a percentage thereof determined by the Railroad Retirement Board to be sufficient to cover the administrative costs attributable to such payments under section 2(b) of that Act.

(e) *Effective date.* This section is effective October 1, 1998.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 22, 1998, 8:45 a.m., and published in the issue of the Federal Register for September 23, 1998, 63 F.R. 50819)

Notice of Rulemaking and Notice of Public Hearing

Guidance Under Section 1032 Relating to the Treatment of a Disposition by One Corporation of the Stock of Another Corporation in a Taxable Transaction

REG–106221–98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the treatment of a disposition by a corporation (the acquiring corporation) of the stock of another corporation (the issuing corporation) in a taxable transaction. The proposed regulations interpret section 1032 of the Internal Revenue Code. The proposed regulations affect corporations and their subsidiaries.

DATES: Written comments must be received by December 22, 1998. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Thursday, January 7, 1999 must be received by Thursday, December 17, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–106221–98), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–106221–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lee A. Dean, (202) 622-7550; concerning submissions and the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1032(a) provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

Before the enactment of section 1032 in 1954, Treasury regulations provided that "where a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another." (Treas. Reg. 111, §29.22(a)–15 (1934)).

As applied, this regulation resulted in the recognition of gain or loss on the disposition by a corporation of its treasury stock, even though the corporation would not have recognized gain or loss on the disposition of newly issued shares. See, e.g., *Firestone Tire & Rubber Co. v. Commissioner*, 2 T.C. 827 (1943). This disparity of treatment gave rise to tax avoidance possibilities. A corporation expecting a gain upon disposition of treasury shares might avoid such gain by canceling its treasury shares and issuing new stock, whereas a corporation might produce a fictitious loss by purchasing its own shares and reselling them at a lower price.

Congress enacted section 1032(a) in 1954 to eliminate this potential disparity between the tax treatment of a disposition by a corporation of its treasury stock and a disposition of newly issued stock. H.R. No. 1337, 83d Cong., 2d Sess. 268 (1954).

Rev. Rul. 74–503 (1974–2 C.B. 117) considers the tax consequences of a parent corporation's transfer to its subsidiary of its own treasury stock in a transaction

to which section 351 applies. The ruling states that "[t]he transfer of [parent] stock was not for the purpose of enabling [the subsidiary corporation] to acquire property by the use of such stock." Rev. Rul. 74–503 holds that, since the basis of previously unissued parent stock in the hands of the parent corporation is zero, the basis of the parent corporation's treasury stock in the hands of the parent corporation is also zero. Accordingly, under the transferred basis rule of section 362(a), the subsidiary corporation's basis of the treasury stock of the parent corporation is also zero (the zero basis result).

Section 1.1032–2(b), applicable to certain triangular reorganizations occurring on or after December 23, 1994, eliminates gain recognition in certain cases when an acquiring corporation (S) acquires property or stock of another corporation (T) in exchange for stock of the corporation (P) in control of S. Section 1.1032–2(b) provides that, "For purposes of §1.1032–1(a), in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), P stock provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization is treated as a disposition by P of its own stock for T's assets or stock, as applicable." Section 1.1032–2(c) provides that S must recognize gain or loss on its exchange of P stock if S did not receive the P stock pursuant to the plan of reorganization.

Section 1.1502–13(f)(6)(ii), initially published as temporary regulations applicable to transactions occurring on or after July 12, 1995 (T.D. 8598, 1995–2 C.B. 188), eliminates gain recognition under certain conditions on a member's disposition of the stock of its common parent. If the requirements of that section are satisfied, §1.1502–13(f)(6)(ii) provides that "If a member, M, would otherwise recognize gain on a qualified disposition of P stock, then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members)." Among other requirements, the member must, pursuant to a plan, transfer the stock "immediately to a nonmember that is not related." See §1.1502–13(f)(6)(ii)(B). The preamble to the temporary regulations explains that the gain relief provisions "prevent taxpayers from being subject to inappropriate taxation on gains in certain transactions." (T.D. 8598, 1995–2 C.B. 188, 189.)

Section 83 provides rules for property, including parent's stock, transferred in connection with the performance of services. Section 83(h) provides, in part, that "there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included . . . in the gross income of the person who performed such services." Section 1.83–6(b) provides that "[e]xcept as provided in section 1032, at the time of the transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property." Section 1.83–6(d) provides that, "[i]f a shareholder of a corporation transfers property to an employee of such corporation . . . in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee . . . ."

Rev. Rul. 80–76 (1980–1 C.B. 15) addresses the use of a parent corporation's stock as compensation to an employee of a subsidiary corporation. Under the facts, A, a shareholder of P, transfers P stock directly to B, an employee of S. The ruling holds in part that, "because section 83 applies to the transfer of P stock to B, S does not recognize gain or loss on the transfer of the P stock."

Explanation of Provisions

Some of the concerns that ultimately led to the enactment of section 1032 are present where a subsidiary corporation holds the stock of a parent corporation. For example, a parent corporation could place treasury stock in a subsidiary corporation in order to attempt to recognize losses if the price of the parent corporation stock goes down, or could sell shares directly if the price rises. See Rev. Rul. 74–503 (1974–2 C.B. 117). The zero basis result limits such planning opportunities.

These tax avoidance possibilities are not present, however, in transactions where one corporation transfers its own stock to another corporation pursuant to a plan by which the second corporation immediately transfers the stock of the first corporation to acquire money or other property. The risk of selective loss recognition does not arise where the stock of the parent corporation is used immediately by the subsidiary corporation to acquire money or other property and therefore does not have sufficient time to depreciate in value. This concept is reflected in Rev. Rul. 74–503, which provides a factual carve-out for transfers of parent corporation stock made for the purpose of enabling a subsidiary corporation to acquire property. Also, the IRS and the Treasury have not applied the zero basis result in such integrated transactions, regardless of whether such a disposition of stock is part of a tax-free reorganization or is part of a taxable acquisition. See §§1.1502–13(f)(6)(ii) and 1.1032–2(b). These proposed regulations provide that no gain or loss is recognized in certain taxable transactions where one corporation immediately disposes of the stock of another corporation pursuant to a plan to acquire money or other property. The IRS and Treasury believe that, in such transactions, the nonapplicability of the zero basis result avoids inappropriate gain recognition and is consistent with the purposes of section 1032. No inference is intended regarding the applicability of the zero basis result to transactions outside of the scope of these proposed regulations.

If the conditions of these proposed regulations are satisfied, no gain or loss is recognized on the disposition of the stock of one corporation (the issuing corporation) by another corporation (the acquiring corporation). The proposed regulations apply if, pursuant to a plan to acquire money or other property, (1) the acquiring corporation acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring corporation would be determined with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a); (2) the acquiring corporation immediately transfers the stock of the issu-

ing corporation to acquire money or other property; and (3) no party receiving stock of the issuing corporation from the acquiring corporation receives a substituted basis in the stock of the issuing corporation within the meaning of section 7701(a)(42). For purposes of this section, "property" includes services. See §1.1032–1.

Mechanics of Proposed Regulations

These proposed regulations adopt the cash purchase model used in §1.1502–13(f)(6)(ii) to provide relief from gain.

In transactions to which the proposed regulations apply, immediately before the disposition of the issuing corporation's stock, the acquiring corporation is treated as purchasing the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring corporation by the issuing corporation (or, if necessary, through intermediate corporations).

As a result of this deemed cash purchase of stock, the acquiring corporation will have a fair market value basis in the issuing corporation's stock pursuant to section 1012, and the issuing corporation will increase its basis in the stock of the acquiring corporation (and, if necessary, the stock basis of intermediate corporations) by that amount. See, e.g., section 358.

No inference is intended regarding whether circular cash flows would be respected apart from this regulation. Similarly, no inference is intended with respect to other methods of avoiding gain on the acquiring corporation's use of the issuing corporation's stock.

A cross-reference in §1.83–6(d) to the proposed regulations clarifies that the mechanics of the proposed regulations—rather than the mechanics of §1.83–6(d)—apply to a corporate shareholder's transfer of its own stock to any person in consideration of services performed for another corporation where the conditions of these proposed regulations are satisfied.

The cash purchase model of these proposed regulations preserves the acquiring corporation's deduction under section 162 for the use of the issuing corporation's stock to compensate the acquiring corporation's employees. In addition, as in Rev. Rul. 80–76, the cash purchase model of these proposed regulations provides that the acquiring corporation will not recognize gain or loss on the transfer of the stock of the issuing corporation. The proposed regulations provide that the cash purchase model is applicable only when the acquiring corporation immediately transfers the stock of the issuing corporation to acquire money or other property. The IRS and the Treasury believe that these proposed regulations address the same issues as in Rev. Rul. 80–76 and, when issued in final form, will render Rev. Rul. 80–76 obsolete.

Stock Options

Section 1032(a), in conjunction with the rules governing the taxation of options, also operates to prevent selective loss recognition in the case where a corporation issues options to buy or sell its own stock. See Deficit Reduction Act of 1984, H.R. Rep. No. 432, 98th Cong., 2d. Sess. pt. 2 1196 (1984) (expanding section 1032(a) to provide that a corporation does not recognize gain or loss with respect to any lapse or acquisition of an option to buy or sell its stock, including treasury stock). As in the case of a subsidiary corporation's dealings in parent corporation stock, however, section 1032 may not always prevent selective loss recognition where a subsidiary corporation deals in options on parent corporation stock. Again, the zero basis result serves to limit such planning opportunities.

The Treasury and the IRS have determined that the concerns underlying section 1032 are not present where the issuing corporation transfers options on its own stock to the acquiring corporation pursuant to a plan by which the acquiring corporation immediately transfers those options to acquire money or other property. Accordingly, these proposed regulations apply to an option issued by an issuing corporation to buy or sell its own stock in the same manner as they apply to stock of an issuing corporation.

Amendment to §1.1032–2

The preamble to the final regulations under §1.1032–2 states that the tax treatment of a disposition by the acquiring corporation (S) of stock options of the corporation (P) in control of S was beyond the scope of the project. (Preamble to Final Regulations under sections 358, 1032 and 1502 [T.D. 8648, 1996–1 C.B. 37, 39].) The IRS and the Treasury believe that the tax treatment of stock options of the issuing corporation in these triangular reorganizations also should be addressed under section 1032. Accordingly, these proposed regulations amend §1.1032–2 to provide that §1.1032–2 shall apply to an option to buy or sell P stock issued by P in the same manner as that section applies to the stock of P.

Proposed Effective Date

The regulations are proposed to be effective on the date that final regulations are published in the **Federal Register.**

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, January 7, 1999 beginning at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must request to speak, and submit an outline of topics to

be discussed and the time to be devoted to each topic by Thursday, December 17, 1998.

A period of ten minutes will be allocated to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Lee A. Dean of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.83–6 is amended by adding two sentences to the end of paragraph (d)(1) to read as follows:

§1.83–6 Deduction by employer.

* * * * *

(d)(1) * * * For special rules that may apply to a corporate shareholder's transfer of its own stock to any person in consideration of services performed for another corporation, see §1.1032–3. The preceding sentence applies to transfers of stock occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

* * * * *

Par. 3. Section 1.1032–2 is amended by:

1. Revising paragraph (e);
2. Adding paragraph (f).

The addition and revision read as follows:

§1.1032–2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

* * * * *

(e) *Stock options.* The rules of this section shall apply to an option to buy or sell P stock issued by P in the same manner as the rules of this section apply to P stock.

(f) *Effective dates.* This section applies to triangular reorganizations occurring on or after December 23, 1994. Paragraph (e) applies to transfers of stock options occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

Par. 4. Section 1.1032–3 is added to read as follows:

§1.1032–3 Disposition of stock or stock options in certain transactions not qualifying under any other nonrecognition provision.

(a) *Scope.* This section provides rules for certain transactions in which one corporation (the acquiring corporation) acquires money or other property (as defined in §1.1032–1) in exchange, in whole or in part, for stock of another corporation (the issuing corporation).

(b) *General rule.* In a transaction to which this section applies, no gain or loss is recognized on the disposition of the issuing corporation's stock by the acquiring corporation. The transaction is treated as if, immediately before the acquiring corporation disposes of the stock of the issuing corporation, the acquiring corporation purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring corporation by the issuing corporation (or, if necessary, through intermediate corporations).

(c) *Applicability.* The rules of this section apply only if, pursuant to a plan to acquire money or other property—

(1) The acquiring corporation acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring corporation would be determined with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a);

(2) The acquiring corporation immediately transfers the stock of the issuing corporation to acquire money or other property; and

(3) No party receiving stock of the issuing corporation from the acquiring corporation receives a substituted basis in the stock of the issuing corporation within the meaning of section 7701(a)(42).

(d) *Stock options.* The rules of this section shall apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules of this section apply to the stock of an issuing corporation.

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

Example 1. (i) *X*, a corporation, owns all of the stock of *Y* corporation. *Y* reaches an agreement with *A*, an individual, to acquire a truck from *A* in exchange for 10 shares of *X* stock with a fair market value of $100. To effectuate *Y*'s agreement with *A*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *A* to acquire the truck.

(ii) In this *Example 1*, no gain or loss is recognized on the disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100 of cash contributed to *Y* by *X*.

Example 2. (i) Assume the same facts as *Example 1*, except that, rather than *X* stock, *X* transfers an option with a fair market value of $100 to buy *X* stock.

(ii) In this *Example 2*, no gain or loss is recognized on the disposition of the *X* stock option by *Y*. Immediately before *Y*'s disposition of the *X* stock option, *Y* is treated as purchasing the *X* stock option from *X* for $100 of cash contributed to *Y* by *X*.

Example 3. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *A*, an individual, is an employee of *Y*. Pursuant to an agreement between *X* and *Y* to compensate *A* for services provided to *Y*, *X* transfers to *A* 10 shares of *X* stock with a fair market value of $100. Under §1.83–6(d), but for this section, the transfer of *X* stock by *X* to *A* would be treated as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a transfer of the *X* stock by *Y* to *A*. But for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 3*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100 of cash contributed to *Y* by *X*.

Example 4. (i) *X*, a corporation, issues 10 shares of *X* stock subject to a substantial risk of forfeiture to compensate *Y*'s employee, *A*, for services. *A* does not have an election under section 83(b) in effect with respect to the *X* stock. *X* retains a reversionary interest in the *X* stock in the event that A forfeits the right to the stock. At the time the stock vests, the 10 shares of *X* stock have a fair market value of $100. Under §1.83–6(d), but for this section, the transfer of the *X* stock by *X* to *A* would be treated, at the time the stock vests, as a contribution of the *X* stock by *X* to the capital of Y, and immediately thereafter, a disposition of the *X* stock by *Y* to *A*. The basis of the *X* stock in the hands of *Y*, but for this section, would be

determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 4*, no gain or loss is recognized on the deemed disposition of *X* stock by *Y* when the stock vests. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing *X*'s stock from *X* for $100 of cash contributed to *Y* by *X*.

Example 5. (i) Assume the same facts as in *Example 4*, except that *Y* (rather than *X*) retains a reversionary interest in the *X* stock in the event that *A* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests.

(ii) This section does not apply to *Y*'s deemed disposition of the *X* shares. For the tax consequences to *Y* on the deemed disposition of the *X* stock, see §1.83–6(b).

(f) *Effective date.* This section applies to transfers of stock or stock options of the issuing corporation occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 22, 1998, 8:45 a.m., and published in the issue of the Federal Register for September 23, 1998, 63 F.R. 50816)

Medical Savings Accounts

Announcement 98–88

PURPOSE

Sections 220(i) and (j) of the Internal Revenue Code provide that if the number of medical savings account (MSA) returns filed for 1997 exceeds 600,000, then October 1, 1998, is a "cut-off" date for the MSA pilot project. If a statutorily specified projection of the number of MSA returns that will be filed for 1998 exceeds 750,000, then October 1, 1998, will also be a "cut-off" date for the MSA pilot project. The Internal Revenue Service (I.R.S.) has determined that the applicable number of MSA returns filed for 1997 is 26,160, and that the applicable number of MSA returns projected to be filed for 1998 is 50,172 (after reduction in each case for statutorily specified exclusions, such as the exclusion for previously uninsured taxpayers). Consequently, October 1, 1998 is not a "cut-off" date and 1998 is not a "cut-off" year for the MSA pilot project.

BACKGROUND

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Code to permit eligible individuals to establish MSAs under a pilot project effective January 1, 1997. The pilot project has a scheduled "cut-off" year of 2000, but may have an earlier "cut-off" year if the number of individuals who have established MSAs exceeds certain numerical limitations. See sections 220(i) and (j).

If a year is a "cut-off" year, section 220(i)(1) generally provides that no individual will be eligible for a deduction or exclusion for MSA contributions for any taxable year beginning after the "cut-off" year unless the individual (A) was an active MSA participant for any taxable year ending on or before the close of the "cut-off" year, or (B) first became an active MSA participant for a taxable year ending after the "cut-off" year by reason of coverage under a high deductible health plan of an MSA-participating employer.

Section 220(j)(2)(A) provides that the numerical limitation for 1998 is exceeded if the number of MSA returns filed on or before April 15, 1998 for taxable years ending with or within the 1997 calendar year, plus the Secretary's estimate of the number of MSA returns for those taxable years which will be filed after April 15, 1998, exceeds 600,000. Section 220(j)-(2)(B) provides, as an alternative test, that the numerical limitation for 1998 is also exceeded if the sum of 90 percent of the sum determined under section 220(j)-(2)(A) for 1998 plus the product of 2.5 and the number of MSAs for taxable years beginning in 1998 that are established during the portion of 1998 preceding July 1 (based on reports by MSA trustees and custodians), exceeds 750,000.

Under section 220(j)(3), in determining whether any calendar year is a "cut-off" year, the MSA of any previously uninsured individual is not taken into account. In addition, section 220(j)(4)(D) specifies that, to the extent practical, all MSAs established by an individual are aggregated and two married individuals opening separate MSAs are to be treated as having a single MSA for purposes of determining the number of MSAs.

A total of 35,887 tax returns reporting MSAs for the 1997 taxable year were filed by April 15, 1998. Of this total, 13,311 taxpayers were reported as being previously uninsured. It has been estimated that an additional 5,781 tax returns reporting MSA contributions for the 1997 taxable year have been or will be filed after April 15, 1998, including 2,197 taxpayers who were previously uninsured. Accordingly, it has been determined that there were 41,668 (35,887 plus 5,781) MSA returns for 1997. Of this total, 15,508 (13,311 plus 2,197) were for taxpayers reported as being previously uninsured. As a result, 26,160 (41,668 minus 15,508) MSA returns count toward the applicable statutory limitation for 1997 MSA returns of 600,000.

Based on the Forms 8851 filed on or before August 1, 1998 by MSA trustees and custodians, it has been determined that 13,034 taxpayers who did not have MSA contributions for 1997 established MSAs for 1998 during the portion of 1998 preceding July 1. Of this total, 2,180 taxpayers were reported by trustees and custodians as previously uninsured, and therefore are not taken into account in determining whether 1998 is a "cut-off" year. In addition, 166 taxpayers were reported by trustees and custodians as excludable from the count because their spouse also established an MSA, and 37 taxpayers had more than one account. Accordingly, the applicable number of MSAs established from January 1, 1998 through June 30, 1998, is 10,651 (13,034 minus (2,180 plus 166 plus 37)). The alternative limitation for 1998 (90 percent of the applicable number of MSA returns for 1997 plus the product of 2.5 and the number of applicable MSAs established from January 1, 1998 through June 30, 1998) is 50,172 (90 percent of 26,160 plus 2.5 times 10,651), which is less than the statutory limit of 750,000. Thus, 1998 is not a cut-off year for the MSA pilot project by reason of either the 1997 MSA returns test of section 220(j)(2)(A) or the alternative test of section 220(j)(2)(B) of the Code.

Questions regarding this announcement may be directed to Felix Zech in the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-4606 (not a toll free number).

Correction of July 1998 Instructions for Form 706

Announcement 98–92

The July 1998 revision of the Instructions for Form 706 contain an error. On page 6, in column 1, in the first paragraph under **Interest computation,** the figure $320,618 is incorrect. The correct figure is $410,000.

Announcement of the Disbarment and Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents, or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Galt, Edward G.	Monterey, CA	CPA	October 25, 1997
Lopez, Andrew L.	Albuquerque, NM	CPA	December 11, 1997
Branch, Jimmie L.	Jacksonville, FL	CPA	January 15, 1998
Harrison, Rebecca A.	Carmichael, CA	Enrolled Agent	March 4, 1998
Mayer, Robert J.	Wexford, PA	CPA	June 4, 1998

Announcement of the Expedited Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions of the applicable regulations:

Name	Address	Designation	Date of Suspension
Clark, Sheila	Houston, TX	CPA	Indefinite from April 21, 1998
Kimes, Larry W.	Austin, TX	Attorney	Indefinite from May 5, 1998
Braiteman, Sheldon	Baltimore, MD	Attorney	Indefinite from June 5, 1998
Pollack, Michael	Guttenberg, NJ	Attorney	Indefinite from June 11, 1998
Eichenbaum, Irving	Huntingdon Valley, PA	CPA	Indefinite from August 4, 1998
Corley, Francis R.	Irmo, SC	CPA	Indefinite from August 4, 1998
Scott, Richard	Lincoln, NE	Attorney	Indefinite from August 4, 1998
Wilson, Douglas D.	Roanoke, VA	Attorney	Indefinite from August 4, 1998
Watkins, Brian R.	Lincoln, NE	Attorney	Indefinite
Congdon Jr., Byron E.	San Bernadino, CA	Attorney	Indefinite from August 4, 1998
Abrams, Robert	Elmsford, NY	CPA	Indefinite from August 4, 1998
Robinson, Doane	Rapid City, SD	CPA	Indefinite from August 4, 1998
Szarwark, Ernest	Nashville, TN	Attorney	Indefinite from August 4, 1998
Roberts, Mark	Norman, OK	CPA	Indefinite from August 4, 1998
Wood, Randall K.	Springfield, MO	Attorney	Indefinite from August 5, 1998
Chappell, Ronald L.	Antelope, CA	CPA	Indefinite from August 12, 1998

Announcement of the Consent Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Makula, John G.	Park Ridge, IL	CPA	April 1, 1998 to March 31, 2003
Slomski, Michael	Gross Pointe Woods, MI	CPA	April 1, 1998 to March 31, 2001
Bozeman Jr., T. Alvin	Sylvester, GA	CPA	May 22, 1998 to November 21, 1999
Parness, Richard A.	Westfield, NJ	CPA	June 1, 1998 to December 31, 1998
Register, Billy	Havana, FL	CPA	Indefinite from July 10, 1998
Cooper, Michael E.	Edina, MN	CPA	August 19, 1998 to February 18, 1999
Minello, Michael J.	Clarks Summit, PA	CPA	August 28, 1998 to April 27, 2001
Holden, William W.	Fairfield, CT	CPA	September 1, 1998 to March 31, 1999
Freeman, Samuel	Bedford, NH	CPA	September 1, 1998 to August 31, 1999
Anders, Kevin	Williamport, MD	CPA	September 1, 1998 to August 31, 2001
Breed, Robert M.	Concord, MA	CPA	September 1, 1998 to February 28, 2001
Sandirk, Paula Brooks	Chehalis, WA	CPA	November 1, 1998 to April 30, 2000
Neuhaus Jr., George	Brewster, NY	CPA	November 1, 1998 to April 30, 2000

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1998–1 through 1998–28 will be found in Internal Revenue Bulletin 1998–29, dated July 20, 1998.

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[1] A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1998–1 through 1998–28 will be found in Internal Revenue Bulletin 1998–29, dated July 20, 1998.

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