Internal Revenue bulletin

Bulletin No. 2014–6
February 3, 2014

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. 9653, page 460.

Final regulation that provide guidance on the tax treatment of a debt instrument with a bond premium carryforward in the holder's final accrual period, including a Treasury bill acquired at a premium.

T.D. 9654, page 461.

This regulation identifies certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of whether it is a surrogate foreign corporation under section 7874 and provides guidance under section 7874 with respect to the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of trade or business of a domestic partnership. Notice 2009–78 (2009–40 IRB 452) superseded.

REG–121534–12, page 473.

Notice of proposed rulemaking by cross-reference to temporary regulations that identify certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of whether it is a surrogate foreign corporation under section 7874 and provide guidance under section 7874 with respect to the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of domestic corporation or of a trade of business of a domestic partnership. Comments and requests for a public hearing must be received by April 17, 2014.

REG–154890–03, page 504.

This notice of proposed rulemaking (NPRM) provides rules for determining a taxable beneficiary's basis in a term interest in a charitable remainder trust upon a sale or other disposition of all interests in the trust to the extent that basis consists of a share of adjusted uniform basis. The NPRM provides that a taxable beneficiary's assignable share of uniform basis upon the sale of exchange of the taxable beneficiary's term interest does not include the charitable remainder trust's undistributed net capital gains or net ordinary income. Comments requested by April 17, 2014.

REG–144468–05, page 474.

The proposed regulations provide guidance on certain provisions of the American Jobs Creation Act of 2004 and conform the regulations to statutory changes in the Taxpayer Relief Act of 1997. The proposed regulations provide guidance on the contribution of built-in loss property to a partnership as well as mandatory basis adjustment provisions where a substantial built-in loss or substantial basis reduction exists. The proposed regulations also modify the basis allocation rules to prevent certain unintended consequences of the current basis allocation rules for substituted basis transactions. Finally, the proposed regulations provide additional guidance on allocations resulting from revaluations of partnership property. Submit electronic or written comments by April 16, 2014.

Announcement 2014–05, page 507.

Partners in Charity, Inc. of West Dundee, IL

Announcement 2014–06, page 508.

Christian Credit Outreach, Inc. of Franklin, OH

Announcement 2014–07, page 508.

The Hope and Dreams Foundation, of Palo Alto, CA

(Continued on the next page)

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

Department of the Treasury
Internal Revenue Service

Announcement 2014–08, page 508.
First Step, Inc. of Manahawkin, NJ

Announcement 2014–09, page 508.
Congressional District Programs, of Falls Church, VA

Announcement 2014–10, page 508.
Capital Gymnastics, Inc. of Springfield, VA

Announcement 2014–11, page 508.
This announcement contains the Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section as decribed in sections 501(c)(3) and 170(c)(2) of the Code.

Announcement 2014–12, page 509.
Life Extension Foundation, Inc. of FT. Lauderdale, FL.

The IRS Mission

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

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section 171.—

T.D. 9653

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

Bond Premium Carryforward

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance on the tax treatment of a debt instrument with a bond premium carryforward in the holder's final accrual period. The regulations in this document provide guidance to holders of Treasury securities and other debt instruments acquired at a premium.

DATES: *Effective Date*: These regulations are effective on January 15, 2014.

Applicability Date: For the date of applicability, see § 1.171–2(a)(4)(i)(C)(*2*).

FOR FURTHER INFORMATION CONTACT: William E. Blanchard, (202) 317-3900 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 4, 2013, the IRS and the Treasury Department published temporary regulations (TD 9609) in the **Federal Register** (78 FR 666) relating to the federal income tax treatment of a debt instrument with a bond premium carryforward in the holder's final accrual period, including a Treasury bill acquired at a premium. *See* § 1.171–2T. On the same day, the IRS and the Treasury Department published a notice of proposed rulemaking (REG–140437–12) cross-referencing the temporary regulations in the **Federal Register** (78 FR 687). No comments were received on the notice of proposed rulemaking. No public hearing was requested or held.

The proposed regulations are adopted without substantive change by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation of provisions

Prior to the issuance of the temporary regulations, the IRS and the Treasury Department had received questions about an electing holder's treatment of a taxable zero coupon debt instrument, including a Treasury bill, acquired at a premium and with a negative yield. In this situation, as explained in more detail below, under the bond premium regulations in effect prior to the issuance of the temporary regulations (the prior regulations), a holder that had elected to amortize bond premium under section 171 generally would have had a capital loss upon the sale, retirement, or other disposition of the debt instrument rather than an ordinary deduction under section 171(a)(1) for all or a portion of the bond premium. The acquisition of a zero coupon debt instrument at a premium and with a negative yield was not contemplated when the prior regulations were revised in 1997 (TD 8746).

Under section 171(c) and § 1.171–4, a holder can elect to amortize bond premium on taxable debt instruments. A holder acquires a debt instrument at a premium if the holder's basis in the debt instrument immediately after its acquisition by the holder exceeds the sum of all amounts payable on the debt instrument after the acquisition date other than payments of qualified stated interest (as defined in § 1.1273–1(c)). The general effect of an election to amortize bond premium on a debt instrument that is a capital asset is to treat the bond premium as an offset to ordinary income rather than as a capital loss.

Under section 171(e) and § 1.171–2, an electing holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the period. As a result, the holder only includes the net amount of interest in income for the period. If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the holder treats the excess as a bond premium deduction under section 171(a)(1) for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the debt instrument in prior accrual periods. If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction under section 171(a)(1), the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period. *See* § 1.171–2(a)(4). Under § 1.1016–5(b), a holder's basis in a taxable debt instrument is reduced by the amount of bond premium used to offset qualified stated interest on the debt instrument and the amount of bond premium allowed as a deduction under section 171(a)(1).

There is no stated interest payable, and therefore no qualified stated interest, on a zero coupon debt instrument, including a Treasury bill. As a result, under § 1.171–2, if a zero coupon debt instrument is acquired at a premium (that is, acquired for an amount greater than its stated principal amount), the bond premium allocable to an accrual period is carried forward to the next accrual period and to each succeeding accrual period. As a result, upon the sale, retirement, or other disposition of the debt instrument, there generally will be a bond premium carryforward in the holder's final accrual period. In this situation, because there is no qualified stated interest to offset the bond premium carryforward and the holder's basis in the debt instrument has not been reduced, under the prior regulations the holder would have had a capital loss in an amount at least equal to the bond premium carryforward.

To address the treatment of a bond premium carryforward in the situation described in the prior paragraph, the temporary regulations added a specific rule for the treatment of a bond premium carryforward determined as of the end of the holder's final accrual period for any taxable debt instrument for which the holder had elected to amortize bond premium. These final regulations adopt the rule in the temporary and proposed regulations. Thus, in the situation described in the prior paragraph, under these final regulations an electing holder deducts all or a portion of the bond premium under section 171(a)(1) when the instrument is sold, retired, or otherwise disposed of rather than recognizing a capital loss.

As noted above, no comments were received on the temporary regulations. The final regulations in this document are substantively the same as the temporary regulations.

Applicability Date

Section 1.171–2(a)(4)(i)(C)(*1*) applies to a debt instrument (bond) acquired on or after January 4, 2013 (the effective/applicability date of the temporary regulations). A taxpayer, however, may rely on this section for a debt instrument (bond) acquired before that date.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It 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 business. No comments were received.

Drafting Information

The principal author of these regulations is William E. Blanchard, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.171–2T to read in part as follows:

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

Par. 2. Section 1.171–2 is amended by adding new paragraph (a)(4)(i)(C) to read as follows:

§ 1.171–2 Amortization of bond premium.

(a) * * *

(4) * * *

(i) * * *

(C) *Carryforward in holder's final accrual period*—(*1*) *Bond premium deduction*. If there is a bond premium carryforward determined under paragraph (a)(4)(i)(B) of this section as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of, the holder treats the amount of the carryforward as a bond premium deduction under section 171(a)(1) for the holder's taxable year in which the sale, retirement, or other disposition occurs. For purposes of § 1.1016–5(b), the holder's basis in the bond is reduced by the amount of bond premium allowed as a deduction under this paragraph (a)(4)(i)(C)(*1*).

(*2*) *Effective/applicability date*. Notwithstanding § 1.171–5(a)(1), paragraph (a)(4)(i)(C)(*1*) of this section applies to a bond acquired on or after January 4, 2013. A taxpayer, however, may rely on paragraph (a)(4)(i)(C)(*1*) of this section for a bond acquired before that date.

* * * * *

1.171–2T [Removed]

Par. 3. Section 1.171–2T is removed.

Par. 4. Section 1.171–3 is amended by revising the fifth sentence in paragraph (b) to read as follows:

§ 1.171–3 Special rules for certain bonds.

* * * * *

(b) * * * However, the rules in § 1.171–2(a)(4)(i)(C) apply to any remaining deflation adjustment attributable to bond premium as of the end of the holder's

accrual period in which the bond is sold, retired, or otherwise disposed of. * * *

* * * * *

John Dalrymple
Deputy Commissioner for Services and Enforcement.

Approved January 7, 2014.

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

(Filed by the Office of the Federal Register on January 14, 2014, 8:45 a.m., and published in the issue of the Federal Register for January 15, 2014, 79 F.R. 2589)

Section 7874.—Rules Relating to Expatriated Entities and their Foreign Parents

26 CFR Part 1: Determining stock ownership for purposes of a whether an entity is a surrogate foreign corporation.

T.D. 9654
DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance for Determining Stock Ownership

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that identify 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.

These regulations also provide guidance with respect to the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of a trade or business of a domestic partnership. These regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or of the trades or businesses of such domestic partnerships. The text of the temporary regulations serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the Bulletin. This document also contains a final regulation that provides a cross-reference to the temporary regulations.

DATES: *Effective Date*: These regulations are effective on January 17, 2014.

Applicability Dates: For dates of applicability, see §§ 1.7874–4T(k) and 1.7874–5T(c).

FOR FURTHER INFORMATION CONTACT: David A. Levine, (202) 317-6937 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

A. Section 7874 — In General

A foreign corporation (foreign acquiring corporation) generally is treated as a surrogate foreign corporation under section 7874(a)(2)(B) of the Internal Revenue Code if pursuant to a plan (or a series of related transactions): (i) 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; (ii) after the 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 by reason of holding stock in the domestic corporation; and (iii) after the acquisition, the expanded affiliated group that includes the foreign acquiring corporation 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, when compared to the total business activities of the expanded affiliated group. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

Under section 7874(c)(2)(B) (statutory public offering rule), stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i) (acquisition) is not taken into account for purposes of calculating the ownership percentage described in section 7874(a)(2)(B)(ii) (ownership fraction). The statutory public offering rule furthers the policy that section 7874 is intended to curtail inversion transactions 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. 142 (2003); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 2005), at 343.

Under section 7874(c)(4), a transfer of properties or liabilities (including by contribution or distribution) is disregarded if such transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. 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. In addition, section 7874(g) grants the Secretary authority to provide regulations necessary to carry out section 7874, including regulations adjusting the application of section 7874 as necessary to prevent the avoidance of the purposes of section 7874.

B. *Notice 2009–78*

On September 17, 2009, the IRS and the Department of the Treasury (Treasury Department) issued Notice 2009–78 (2009–40 IRB 452) (notice), which announced that regulations would be issued under section 7874 to identify certain stock of a foreign acquiring corporation that is not taken into account in determining the ownership fraction. See § 601.601(d)(2)(ii)(*b*) of this chapter.

The notice states that regulations will provide that stock of the foreign acquiring corporation issued in exchange for "nonqualified property" in a transaction related to the acquisition is not taken into account for purposes of the ownership fraction, without regard to whether such stock is publicly traded on the date of issuance or otherwise. The notice further provides that the term nonqualified property generally will mean: (i) cash or cash equivalents; (ii) marketable securities as defined in section 453(f)(2); and (iii) any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874.

The notice also states that regulations will clarify that certain stock of the foreign acquiring corporation, including certain stock otherwise described in the statutory public offering rule, nonetheless will be taken into account for purposes of the ownership fraction. Specifically, the notice states that marketable securities will not include stock of (or a partnership interest in) a member of the expanded affiliated group (as defined in section 7874(c)(1)) that, after the acquisition, includes the foreign acquiring corporation, unless a principal purpose of issuing the stock of the foreign acquiring corporation in exchange for such stock or partnership interest was the avoidance of the purposes of section 7874. Accordingly, even if issued in a public offering, stock of the foreign acquiring corporation issued in exchange for stock of (or a partnership interest in) a member of the expanded affiliated group that, after the acquisition, includes the foreign acquiring corporation, will be taken into account for purposes of the ownership fraction, unless a principal purpose of issuing the stock of the foreign acquiring corporation in exchange for such stock or partnership interest was the avoidance of the purposes of section 7874.

The notice provides that the regulations will apply to acquisitions completed on or after September 17, 2009.

The temporary regulations set forth the rules described in the notice, subject to certain modifications, in part, to address comments received.

Explanation of Provisions

A. *New Exclusion Rule Modifies the Statutory Public Offering Rule*

Under the statutory public offering rule of section 7874(c)(2)(B), stock of the foreign acquiring corporation is not taken into account for purposes of the ownership fraction if the stock is sold in a public offering related to the acquisition. Absent the statutory public offering rule, the purposes of section 7874 could be avoided by having the foreign acquiring corporation issue stock to the public in exchange for cash in order to reduce the ownership fraction while not significantly altering the manner in which the domestic entity did business before the inversion transaction. Consistent with the notice, 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. For example, a private placement of the stock of a foreign acquiring corporation in exchange for cash raises the same policy concern that the ownership fraction will be inappropriately reduced by increasing the net assets of the foreign acquiring corporation.

Consistent with the notice, the IRS and the Treasury Department also believe that the statutory public offering rule can result in an over-inclusive application of section 7874 to certain business combinations. That is, the statutory public offering rule can apply to certain business combinations in which the unrelated shareholders of a foreign target corporation receive publicly traded stock of the foreign acquiring corporation in transactions that, while they do increase the net assets of the foreign acquiring corporation, generally are expected to meaningfully alter the way the expanded affiliated group that includes the foreign acquiring corporation does business and therefore such publicly traded stock should be taken into account in calculating the ownership fraction.

To address these concerns, the temporary regulations modify the statutory public offering rule (as modified, the exclusion rule). Specifically, the exclusion rule provides that, subject to a *de minimis* exception, disqualified stock (described in section B of this preamble) is excluded from the denominator of the ownership fraction. Because the determination of whether stock of the foreign acquiring corporation is disqualified stock is made without regard to whether it is publicly traded at the time of the transfer or at any other time, the exclusion rule under the temporary regulations addresses the potentially under-inclusive application of section 7874 under the statutory public offering rule. Moreover, although the notice excluded stock of the foreign acquiring corporation from the denominator of the ownership fraction only when there was an issuance of such stock, the IRS and the Treasury Department do not believe the exclusion rule should be limited to stock of the foreign acquiring corporation that is issued in the transaction. Accordingly, under the temporary regulations, disqualified stock is stock of the foreign acquiring corporation that is transferred in a manner described in the temporary regulations, regardless of whether the transfer occurs by reason of an issuance, sale, distribution, exchange, or any other type of disposition and regardless of whether the stock is transferred by the foreign acquiring corporation or another person.

The temporary regulations describe all situations in which stock will be excluded from the denominator of the ownership fraction under section 7874(c)(2)(B). Thus, even when a foreign acquiring corporation issues stock in a public offering, the statutory public offering rule will not exclude such stock from the denominator unless the stock is disqualified stock. Accordingly, the exclusion rule also addresses the potentially over-inclusive application of the statutory public offering rule.

Because stock of the foreign acquiring corporation held by former shareholders or former partners by reason of holding stock or a partnership interest in the domestic entity will never be subject to the nonqualified property rule or the associated liability rule, the exclusion rule will never apply to such stock.

B. *Identifying Stock of the Foreign Acquiring Corporation that is Disqualified Stock*

1. *Stock transferred in a transaction that does not increase the net assets of the foreign acquiring corporation is not disqualified stock*

Comments questioned whether the rules described in the notice would exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation that is transferred by persons that are not members of the expanded affiliated group that includes the foreign acquiring corporation in exchange for nonqualified property. Such a transfer may occur, for example, if an individual holds stock of the foreign acquiring corporation at the time of the acquisition and sells such stock to another individual for cash (which is nonqualified property) in a transaction related to the acquisition.

The purpose of the exclusion rule is to prevent certain stock of the foreign acquiring corporation that is transferred in a transaction that increases the net assets of the foreign acquiring corporation from inappropriately increasing the denominator of the ownership fraction and thereby reducing the ownership fraction. Thus, provided that the stock of the foreign acquiring corporation that is transferred is not hook stock (that is, where the foreign acquiring corporation holds a direct or indirect interest in the selling shareholder), the IRS and the Treasury Department do not believe that the exclusion rule should apply to transfers of stock by a shareholder of the foreign acquiring corporation to another person because such transfers do not increase the net assets of the foreign acquiring corporation. Accordingly, the temporary regulations provide that stock of the foreign acquiring corporation is disqualified stock if the stock is transferred in exchange for certain property but only to the extent the exchange increases the net assets of the foreign acquiring corporation (that is, the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities). The extent to which such an exchange increases the net assets of the foreign acquiring corporation is determined on a transfer-by-transfer basis. Therefore, a related transaction that might decrease the net assets of the foreign acquiring corporation, such as a related distribution by the foreign acquiring corporation with respect to its stock, is not taken into account for purposes of determining whether a specific transfer of stock in exchange for property increases the net assets of the foreign acquiring corporation.

2. *Stock of the foreign acquiring corporation that generally is disqualified stock*

Under the temporary regulations, stock of the foreign acquiring corporation that is transferred in any transaction described in section B.2.a. or B.2.b. of the preamble is treated as disqualified stock if the transaction is related to the acquisition, unless the exception described in section B.1. of the preamble applies.

A. *Transfers of stock in exchange for nonqualified property*

Disqualified stock includes stock of the foreign acquiring corporation that is transferred to a person other than the domestic entity in exchange for nonqualified property (nonqualified property rule). Transfers of stock of the foreign acquiring corporation to the domestic entity in exchange for nonqualified property are not subject to the nonqualified property rule because such transferred stock generally is treated as either: (i) stock that is received by reason of holding stock or a partnership interest in the domestic entity (for example, if the domestic entity is a corporation that distributes the transferred stock to its shareholders in cancellation of their stock in the domestic entity), and, therefore, generally is included in the numerator and the denominator of the ownership fraction; or (ii) disqualified stock under the associated obligation rule described in paragraph (b) of this section B.2. of the preamble.

The term *nonqualified property* means: (i) cash or cash equivalents; (ii) marketable securities within the meaning of section 453(f)(2), as modified by the temporary regulations; (iii) a disqualified obligation; or (iv) any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874. A disqualified obligation is an obligation (as defined in § 1.752–1(a)(4)(ii)) of any of the following persons: (i) a member of the expanded affiliated group that includes the foreign acquiring corporation; (ii) a former shareholder (within the meaning of § 1.7874–2(b)(2)) or former partner (within the meaning of § 1.7874–2(b)(3)) of the domestic entity; or (iii) a person that, before or after the acquisition, either owns stock of, or a partnership interest in, any person described in (i) or (ii) or is related (within the meaning of section 267 or 707(b)) to any such persons.

In the notice, the definition of nonqualified property includes cash, cash equivalents, and marketable securities, but not a disqualified obligation. Nevertheless, based on further consideration, the IRS and the Treasury Department believe that, for purposes of the temporary regulations, a transfer of stock of the foreign acquiring corporation in exchange for a disqualified obligation should be treated similarly to transfers of stock of the foreign acquiring corporation in exchange for cash, cash equivalents, and marketable securities because such transfers present similar opportunities to inappropriately reduce the ownership fraction by increasing the net assets of the foreign acquiring corporation.

Consistent with the notice, the temporary regulations exclude from the definition of marketable securities (which constitute nonqualified property) 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 related to the acquisition, unless a principal purpose of the acquisition of such stock (or partnership interest) was the avoidance of the purposes of section 7874. Thus, for example, subject to an anti-abuse rule, publicly traded stock of a foreign target corporation does not constitute marketable securities for purposes of the temporary regulations and therefore is not nonqualified property.

In addition, the IRS and the Treasury Department believe that a transfer of stock of the foreign acquiring corporation in exchange for the satisfaction or the assumption of an obligation of the transferor should be treated similarly to a transfer of stock of the foreign acquiring corporation in exchange for nonqualified property because such a transfer also presents opportunities to inappropriately reduce the ownership fraction by increasing the net assets of the foreign acquiring corporation. For example, if the foreign acquiring corporation is a debtor with respect to an obligation and satisfies the obligation with its stock, the transfer of the stock to the creditor in satisfaction of the obligation increases the net assets of the foreign acquiring corporation, and, absent a special rule, would increase the denominator of the ownership fraction. Accordingly, under the temporary regulations, disqualified stock includes stock of the foreign acquiring corporation that is transferred to a person other than the domestic entity in exchange for the satisfaction or the assumption of an obligation of the transferor. Solely for purposes of applying the temporary regulations, stock of the foreign acquiring corporation described in the preceding sentence is treated as if it were transferred to the transferee in exchange for an amount of cash (which is nonqualified property) equal to the fair market value of the stock of the foreign acquiring corporation that is transferred in exchange for the satisfaction or the assumption of the obligation.

One comment suggested that the phrase "related to the acquisition" in section 7874(c)(2)(B) can be read to suggest that the statutory public offering rule should apply only if the proceeds of a public offering are used to acquire, or fund the business of, the domestic entity. Accordingly, the comment suggested that the statutory public offering rule should not apply if, for example, the proceeds are used to acquire business assets unrelated to those of the domestic entity. Another comment recommended an exception to the statutory public offering rule for offerings that further a significant business purpose, such as allowing an insolvent domestic entity to continue its operations. The IRS and the Treasury Department believe that the use of the offering proceeds is irrelevant to the application of the statutory public offering rule. Neither the statute nor the legislative history indicates that Congress intended for the statutory public offering rule to apply based on the use of the proceeds. Accordingly, the temporary regulations do not adopt these recommendations. Therefore, the determination of whether stock of the foreign acquiring corporation transferred in exchange for nonqualified property is disqualified stock is made without regard to the use of the nonqualified property.

B. *Subsequent transfers of stock in exchange for the satisfaction or the assumption of an obligation associated with property exchanged*

The IRS and the Treasury Department believe that a transfer of stock of the foreign acquiring corporation in exchange for property when the transferee subsequently transfers the stock in exchange for the satisfaction or the assumption of the transferee's obligations associated with the property exchanged also presents opportunities to inappropriately decrease the ownership fraction. For example, assume that a domestic entity (DE) has $100x of assets employed in a trade or business and $25x of obligations that arose from conducting that trade or business. A foreign acquiring corporation (FA) wants to acquire all the assets of DE in a transaction in which DE will liquidate. FA could acquire the $100x of assets of DE by issuing $75x of stock and assuming the $25x of obligations, in which case DE would distribute the $75x of FA stock to its shareholders in liquidation. Alternatively, FA could acquire the $100x of assets of DE by issuing $100x of stock and not assuming the $25x of obligations, in which case DE would transfer $25x of FA stock to satisfy the $25x of obligations and distribute the remaining $75x of FA stock to its shareholders in liquidation. In either case, the shareholders of DE will receive $75x of FA stock by reason of holding stock in DE and FA will own the $100x of assets formerly owned by DE; however, absent a special rule, the denominator of the ownership fraction would not be the same in both cases. In the first case, the denominator would include only $75x of FA stock and FA would owe the $25x of obligations. In the second case, the denominator would include $100x of FA stock and FA would not owe the $25x of obligations. In the latter case, the ownership fraction would be inappropriately reduced.

Accordingly, to address such transfers, the temporary regulations provide that disqualified stock includes stock of the foreign acquiring corporation transferred to a person (including the domestic entity) in exchange for property to the extent, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers the stock in exchange for the satisfaction or the assumption of an obligation associated with the property exchanged (associated obligation rule). An obligation is associated with property exchanged if, for example, the obligation arose from the conduct of a trade or business in which the property exchanged has been used, regardless of whether the obligation is a non-recourse obligation. For an example of a rule that applies when liabilities associated with a trade or business are assumed by a corporate transferee of the trade or business in certain nonrecognition exchanges, see section 358(h)(2).

In this case, the requirement that the transfer of stock of the foreign acquiring corporation increase the net assets of the foreign acquiring corporation applies only with respect to the transfer of the stock in exchange for property of the transferee, and not with respect to the subsequent transfer of the stock of the foreign acquiring corporation by the transferee in exchange for the satisfaction or the assumption of an obligation of the transferee.

Unlike the nonqualified property rule, which does not apply to a transfer of stock of the foreign acquiring corporation to the domestic entity, the associated obligation rule may apply to a transfer of stock of the foreign acquiring corporation to the domestic entity to the extent the stock is subsequently transferred by the domestic entity in exchange for the satisfaction or the assumption of one or more of the domestic entity's obligations associated with the property exchanged. This treatment is appropriate because, in such a case, the stock of the foreign acquiring corporation transferred will not be included in the numerator of the ownership fraction (because the creditor with respect to the obligation or the person that assumes the obligation, as the case may be, does not receive the stock of the foreign acquiring corporation by reason of holding stock or a partnership interest in the domestic entity).

The temporary regulations limit the application of the associated obligation rule when the property exchanged (including cash deemed to be exchanged when stock of the foreign acquiring corporation is transferred in exchange for the satisfaction or the assumption of an obligation of the transferor) includes nonqualified property and the person exchanging the property is not the domestic entity. The limitation has the effect of treating a portion of the obligation as being satisfied with stock of the foreign acquiring corporation that is disqualified stock under the nonqualified property rule (with the result that such portion does not give rise to additional disqualified stock under the associated obligation rule) and the remaining portion of the obligation as being satisfied with stock of the foreign acquiring corporation that is not disqualified stock under the nonqualified property rule (with the result that satisfaction of this portion of the obligation with stock of the foreign acquiring corporation gives rise to additional disqualified stock under the associated obligation rule). The portions of an obligation described in the preceding sentence are determined based on the relative amount of nonqualified property and qualified property exchanged, respectively. This limitation does not apply when stock of the foreign acquiring corporation is transferred to the domestic entity because the nonqualified property rule does not apply to such transfers of stock.

C. *Different Treatment for Stock and Asset Acquisitions*

One comment noted that under the notice the amount of nonqualified property exchanged for stock of the foreign acquiring corporation can differ depending on whether the stock or assets of a corporation are acquired. For example, if a foreign acquiring corporation issues stock in exchange for all of the stock of another foreign corporation in a transaction related to the acquisition, none of the stock of the foreign acquiring corporation is considered to be issued in exchange for nonqualified property, without regard to whether the acquired foreign corporation held nonqualified property, unless a principal purpose of the acquisition of the stock of such acquired foreign corporation is the avoidance of the purposes of section 7874. The comment further noted that, if the transaction instead is structured as the acquisition of all the assets of the acquired foreign corporation, the stock of the foreign acquiring corporation would not be taken into account to the extent it is treated as issued in exchange for nonqualified property held by the acquired foreign corporation. The comment suggested that the dissimilar treatment is not supported by policy and raises form-over-substance concerns.

The structure of a transaction as an acquisition of stock or assets can often result in different U.S. tax consequences. In addition, the IRS and the Treasury Department believe that the complexity of adopting rules to harmonize the treatment of stock and asset acquisitions, such as by applying a look-through approach to stock acquisitions, would outweigh the benefits of consistent treatment. Moreover, the IRS and the Treasury Department believe that the treatment of property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874 as nonqualified property addresses the concern that taxpayers may exploit this dissimilar treatment by engaging in transactions intended to convert nonqualified property into stock that is not nonqualified property. See *Example 2* of § 1.7874–4T(j) of the temporary regulations. Accordingly, the temporary regulations do not adopt this recommendation.

D. *De Minimis Exception*

Comments asserted that both the statutory public offering rule and the rule set forth in the notice that disregards stock issued in exchange for nonqualified property can lead to inappropriate results when the former owners of the domestic entity own only a minimal equity interest in the foreign acquiring corporation after the acquisition. These comments recommended that, in such a case, the regulations provide exceptions from the application of those rules.

First, comments recommended an exception for large cash public or private offerings where the cash remains in the foreign acquiring corporation and results in a change of ownership in the domestic entity of such a magnitude that the predominant effect of the transaction is that of a sale or joint venture. Because such offerings have independent economic significance, comments suggested that they should not be treated as "related to" the acquisition, so that they would be taken into account for purposes of the ownership fraction.

Second, comments recommended an exception for transactions that in substance resemble a purchase by the foreign acquiring corporation of a substantial portion of the stock of the domestic entity from the former owners of the domestic entity. The comments asserted that this may occur, for example, when a significant amount of the consideration received by the former owners of the domestic entity is cash (or other nonqualified property) that, related to the acquisition, was received by the foreign acquiring corporation in exchange for its stock (which stock would not be taken into account in determining the ownership fraction under the notice). The comments stated that section 7874 should not apply to such transactions because the former owners of the domestic entity sold the majority of their interests in the domestic entity. These comments recommended that the exclusion rule be limited to transactions in which the former owners of the domestic entity own at least a threshold percentage of the equity of the foreign acquiring corporation.

The IRS and the Treasury Department agree that an exception from the exclusion rule is appropriate for certain transactions, but believe that any such exception should apply only when the former owners of the domestic entity own a *de minimis* equity interest in the foreign acquiring corporation after the acquisition. Accordingly, the temporary regulations provide that the exclusion rule will not apply to certain transactions involving unrelated parties if the ownership fraction, determined without regard to the exclusion rule, is less than five percent (by vote and value).

E. *Effect of Subsequent Transfers of Stock of the Foreign Acquiring Corporation Related to the Acquisition*

Comments questioned the effect on the ownership fraction of certain subsequent transfers of stock of the foreign acquiring corporation in transactions related to the acquisition. This may occur, for example, when former shareholders of the domestic corporation receive stock of the foreign acquiring corporation by reason of holding stock in the domestic corporation and then transfer that stock to another person pursuant to the terms of a binding commitment that was in effect at the time of the acquisition.

The IRS and the Treasury Department believe that determining the ownership fraction by taking into account such subsequent transfers of stock of the foreign acquiring corporation could inappropriately reduce the numerator of the ownership fraction and thereby reduce the ownership fraction. For example, if such a subsequent transfer of stock of the foreign acquiring corporation were taken into account in determining the ownership fraction, the exclusion rule could be avoided by restructuring an inversion transaction so that an investor participates by purchasing stock of the foreign acquiring corporation received by a former owner of the domestic entity instead of purchasing newly issued stock of the foreign acquiring corporation. Accordingly, the temporary regulations clarify that stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) will not cease to be so described as a result of any subsequent transfer of the stock by the former shareholder or former partner of the domestic entity that received such stock, even if the subsequent transfer is related to the acquisition.

In addition, the IRS and the Treasury Department continue to study the extent to which such subsequent transfers of stock of the foreign acquiring corporation should be taken into account in applying section 7874(c)(2)(A) (which disregards stock held by members of the expanded affiliated group that includes the foreign acquiring corporation) and § 1.7874–1 (which provides exceptions to the application of section 7874(c)(2)(A)) (collectively, with the rule of section 7874(c)(2)(A), the expanded affiliated group rules). Section K of the preamble to temporary and final regulations published on June 12, 2009 (TD 9453, 2009-28 IRB 114), describes certain divisive transactions described in section 355 that involve subsequent distributions by a corporation of the stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii). These issues can also arise when there is a subsequent sale by a corporation of the stock of the foreign acquiring corporation, or in connection with an acquisitive asset reorganization described in section 368 in which the target corporation distributes such stock. In each of these cases, a corporation receives and only temporarily holds the stock of the foreign acquiring corporation, and, after the transfer of such stock, the corporation no longer is a member of the expanded affiliated group that includes the foreign acquiring corporation. The IRS and the Treasury Department request comments on whether different results may be appropriate depending on whether the corporation that receives the stock of the foreign acquiring corporation and only temporarily holds that stock is a foreign or domestic corporation.

F. *Interaction of Exclusion Rule with Expanded Affiliated Group Rules*

One comment questioned the interaction of the rules set forth in the notice with the expanded affiliated group rules in cases other than those involving subsequent transfers of the stock of the foreign acquiring corporation (which are discussed in section E of this preamble). The comment suggested that stock of the foreign acquiring corporation that is disregarded under the rules set forth in the notice nonetheless should be taken into account for purposes of determining whether an entity is a member of an expanded affiliated group that includes the foreign acquiring corporation under section 7874(c)(2)(A), as well as for purposes of the "internal group restructuring" and "loss of control" exceptions to section 7874(c)(2)(A) provided in § 1.7874–1(c). The comment further suggested that the policy underlying the internal group restructuring and loss of control exceptions requires that stock that would be included in the denominator of the ownership fraction under those exceptions should continue to be so included even if such stock would otherwise be excluded under the exclusion rule.

The IRS and the Treasury Department believe that the policies underlying the exclusion rule differ from those underlying the expanded affiliated group rules such that they should operate independently. Because the exclusion rule and the expanded affiliated group rules operate independently, the IRS and the Treasury Department do not believe that qualification for the internal group restructuring or loss of control exceptions should cause stock of the foreign acquiring corporation that would otherwise be excluded from the denominator of the ownership fraction under the exclusion rule to be included in the denominator of the ownership fraction. Instead, the IRS and the Treasury Department believe that the *de minimis* exception is the appropriate exception to the exclusion rule when the former owners own only a small equity interest in the foreign acquiring corporation after the acquisition. Accordingly, the temporary regulations provide that stock of the foreign acquiring corporation to which the exclusion rule applies is not included in the denominator of the ownership fraction regardless of whether it would otherwise be included in the denominator as a result of the acquisition being described in the internal group restructuring exception or loss of control exception. That is, stock of the foreign acquiring corporation will not be taken into account in the denominator of the ownership fraction if either the exclusion rule or the expanded affiliated group rule set forth in section 7874(c)(2)(A) and § 1.7874–1(b) applies to such stock. However, consistent with the comment, the temporary regulations provide that the exclusion rule does not apply for purposes of applying the expanded affiliated group rules.

G. *Certain Public Offerings*

The IRS and the Treasury Department are aware that the *de minimis* exception (described in section D of this preamble) may facilitate the acquisition of a domestic corporation by a foreign corporation in circumstances that implicate the policies underlying section 7874. This may occur, for example, in connection with the buyout of a publicly traded domestic corporation. In such a transaction, the buyer may contribute cash to a newly formed foreign acquiring corporation that uses such cash, along with the proceeds from borrowings and a small amount of its stock, to acquire all of the stock of a publicly traded domestic corporation. The small amount of stock of the foreign acquiring corporation often is issued to the management of the domestic corporation. After a period of time, the buyer may sell its stock of the foreign acquiring corporation pursuant to a public offering. The public offering of the stock of the foreign acquiring corporation may have been one of the intended exit strategies of the buyer when it organized the foreign acquiring corporation to acquire the stock of the domestic corporation.

The IRS and the Treasury Department believe that these transactions, which have the effect of converting a publicly traded domestic corporation into a publicly traded foreign corporation over time, can be viewed as inconsistent with the policies underlying section 7874. The IRS and the Treasury Department are studying these transactions and request comments on the application of section 7874 to such transactions.

H. *Effective/Applicability Date*

The rules described in the notice and set forth in the temporary regulations apply to acquisitions completed on or after September 17, 2009. All other rules set forth in the temporary regulations apply to acquisitions completed on or after January 16, 2014. However, a taxpayer may elect to apply all the rules of the temporary regulations to acquisitions completed before January 16, 2014, if the taxpayer applies all of the rules consistently to all acquisitions completed before such date.

Comments recommended an exception to the rules described in the notice for transactions that were subject to a binding commitment but not completed before September 17, 2009. Because the rules described in the notice address transactions that are intended to avoid the purposes of section 7874, the IRS and the Treasury Department do not believe that providing a binding commitment exception is appropriate. Therefore, the applicability date in the temporary regulations does not include a binding commitment exception.

No inference is intended as to the treatment of transactions described in the temporary regulations under the law before the applicability date of these regulations. The IRS may, where appropriate, challenge such transactions under applicable provisions, including under section 7874(c)(4) or judicial doctrines such as the substance-over-form doctrine.

Effect on Other Documents

Notice 2009–78 (2009–40 IRB 452) is obsolete as of January 16, 2014.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble of the cross-referenced notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f), these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of the temporary regulations are David A. Levine of the Office of Associate Chief Counsel (International) and Mary W. Lyons, formerly of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

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 as follows:

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

Section 1.7874–4T also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–5T also issued under 26 U.S.C. 7874(c)(6) and (g).

Par. 2. Section 1.7874–1 is amended by adding a sentence at the end of paragraph (c)(1) to read as follows:

§ 1.7874–1 Disregard of affiliate-owned stock.

* * * * *

(c) * * * (1) * * * For rules addressing the interaction of this section and § 1.7874–4T, see § 1.7874–4T(h).

* * * * *

Par. 3. Section 1.7874–4T is added to read as follows:

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

(a) *Scope*. This section identifies certain stock of the foreign acquiring corporation that is disregarded in determining the ownership fraction (as defined in paragraph (i)(9) of this section) and modifies the scope of section 7874(c)(2)(B). Paragraph (b) of this section sets forth the general rule that certain stock of the foreign acquiring corporation, and only such stock, is treated as stock described in section 7874(c)(2)(B) and therefore is excluded from the denominator of the ownership fraction. Paragraph (c) of this section identifies the stock of the foreign acquiring corporation that is subject to paragraph (b) of this section. Paragraph (d) of this section provides a *de minimis* exception to the application of the general exclusion rule of paragraph (b) of this section. Paragraph (e) of this section addresses transfers of stock of the foreign acquiring corporation involving certain obligations. Paragraph (f) of this section provides rules for certain transfers of stock of the foreign acquiring corporation involving multiple properties or obligations. Paragraph (g) of this section provides rules for the treatment of partnerships, and paragraph (h) 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 (i) of this section provides definitions. Paragraph (j) of this section provides examples illustrating the application of the rules of this section. Paragraph (k) of this section provides dates of applicability, and paragraph (l) of this section provides the date of expiration.

(b) *Exclusion of disqualified stock under section 7874(c)(2)(B)*. Except as provided in paragraph (d) of this section, disqualified stock (as determined under paragraph (c) of this section) is treated as stock described in section 7874(c)(2)(B) and therefore is not included in the denominator of the ownership fraction. Section 7874(c)(2)(B) shall not apply to exclude stock from the denominator of the ownership fraction that is not disqualified stock.

(c) *Disqualified stock*—(1) *General rule*. Except as provided in paragraph (c)(2) of this section, disqualified stock is stock of the foreign acquiring corporation that is transferred in an exchange described in paragraph (c)(1)(i) or (c)(1)(ii) of this section that is related to the acquisition. This paragraph (c) applies without regard to whether the stock of the foreign acquiring corporation is publicly traded at the time of the transfer or at any other time.

(i) *Exchange for nonqualified property*. The stock is transferred to a person other than the domestic entity in exchange for nonqualified property. See *Example 1*, *Example 2*, *Example 5*, *Example 7*, and *Example 8* of paragraph (j) of this section for illustrations of this paragraph (c)(1)(i).

(ii) *Certain obligations associated with property exchanged for stock*. Except as otherwise provided in this paragraph (c)(1)(ii), the stock is transferred to a person in exchange for property and, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers such stock in exchange for the satisfaction or the assumption of one or more obligations associated with the property exchanged. An obligation is associated with property exchanged if, for example, the obligation arose from the conduct of a trade or business in which the property exchanged has been used, regardless of whether the obligation is a non-recourse obligation. If any of the property exchanged constitutes nonqualified property and the transferee is not the domestic entity, the amount of stock described in this paragraph (c)(1)(ii) is limited to the product of:

(A) The fair market value of the stock subsequently transferred by the transferee in exchange for the satisfaction or the assumption of such obligations; and

(B) A fraction, the numerator of which is the amount of qualified property exchanged by the transferee, and the denominator of which is the total amount of property exchanged by the transferee. See *Example 5* of paragraph (j) of this section for an illustration of this paragraph (c)(1)(ii).

(2) *Stock transferred in an exchange that does not increase the fair market value of the assets or decrease the amount of liabilities of the foreign acquiring corporation*. Stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities. This paragraph (c)(2) is applied to an exchange without regard to any other exchange described in paragraph (c)(1)(i) or (c)(1)(ii) of this section or any other transaction related to the acquisition. See *Example 3* and *Example 6* of paragraph (j) of this section for illustrations of this paragraph (c)(2).

(d) *Exception to exclusion of disqualified stock*—(1) *De minimis ownership*. Except as provided in paragraph (d)(2) of this section, paragraph (b) of this section does not apply if both:

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

(ii) After the acquisition and all transactions related to the acquisition, if any, are completed, former shareholders (within the meaning of § 1.7874–2(b)(2)) or former partners (within the meaning of § 1.7874–2(b)(3)), 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) any member of the expanded affiliated group that includes the foreign acquiring corporation. See *Example 4* of paragraph (j) of this section for an illustration of this paragraph (d).

(2) *Stock issued to avoid the purposes of section 7874*. The exception in paragraph (d)(1) of this section does not apply to disqualified stock that is transferred in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874.

(e) *Satisfaction or assumption of obligations*. Except to the extent paragraph (c)(1)(ii) of this section applies, this paragraph (e) applies if, in a transaction related to the acquisition, stock of the foreign acquiring corporation is transferred to a person other than the domestic entity in exchange for the satisfaction or the assumption of one or more obligations of the transferor. In such a case, solely for purposes of this section, the stock of the foreign acquiring corporation is treated as if it is transferred in exchange for an amount of cash equal to the fair market value of such stock.

(f) *Transactions involving multiple properties*. For purposes of this section, if stock and other property are exchanged for qualified property and nonqualified property, the stock is treated as transferred in exchange for the qualified property or nonqualified property, respectively, based on the relative value of the property. See also § 1.7874–2(f)(2) (allocating stock of the foreign acquiring corporation between an interest in the domestic entity and other property).

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

(h) *Interaction with expanded affiliated group rules*. Disqualified 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 (c)(3), respectively. However, such disqualified 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). See *Example 7* and *Example 8* of paragraph (j) of this section for illustrations of this paragraph (h).

(i) *Definitions*. The following definitions apply for purposes of this section:

(1) An *acquisition* is an acquisition described in section 7874(a)(2)(B)(i).

(2) A *domestic entity* is a domestic corporation or domestic partnership described in section 7874(a)(2)(B)(i).

(3) An *expanded affiliated group* is an affiliated group defined in section 7874(c)(1) determined as of the end of the day on which the acquisition is completed. A *member of the expanded affiliated group* is an entity included in the expanded affiliated group.

(4) A *foreign acquiring corporation* is a foreign corporation described in section 7874(a)(2)(B).

(5) An *interest in a partnership* has the meaning provided under § 1.7874–2(b)(4), and therefore includes a capital or profits interest.

(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, unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of section 7874. See *Example 3* of paragraph (j) of this section for an illustration of this paragraph (i)(6).

(7) *Nonqualified property* is property described in paragraphs (i)(7)(i) through (i)(7)(iv) of this section. *Qualified property* is property other than nonqualified property.

(i) Cash or cash equivalents.

(ii) Marketable securities, within the meaning of paragraph (i)(6) of this section.

(iii) An obligation owed by any of the following:

(A) A member of the expanded affiliated group that includes the foreign acquiring corporation;

(B) A former shareholder (within the meaning of § 1.7874–2(b)(2)) or former partner (within the meaning of § 1.7874–2(b)(3)) of the domestic entity; or

(C) A person that, before or after the acquisition, either owns stock of, or a partnership interest in, a person described in paragraph (i)(7)(iii)(A) or (i)(7)(iii)(B) of this section or is related (within the meaning of section 267 or 707(b)) to such a person. See *Example 5* of paragraph (j) of this section for an illustration of this paragraph (i)(7)(iii).

(iv) Any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874.

See *Example 2* of paragraph (j) of this section for an illustration of this paragraph (i)(7)(iv).

(8) An *obligation* has the meaning set forth in § 1.752–1(a)(4)(ii), provided that the obligation is not otherwise treated as stock for purposes of section 7874 (see, for example, § 1.7874–2(i), which treats certain interests, including certain creditor claims, as stock).

(9) The *ownership fraction* is the ownership percentage described in section 7874(a)(2)(B)(ii), expressed as a fraction.

(10) A *transfer* is, with respect to stock of the foreign acquiring corporation, an issuance, sale, distribution, exchange, or any other disposition of such stock.

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

(1) FA, FMS, FS, and FT are foreign corporations, all of which have only one class of stock issued and outstanding;

(2) DMS and DT are domestic corporations;

(3) P and R are corporations that may be either domestic or foreign;

(4) PRS is a partnership with individual partners;

(5) The *de minimis* ownership exception in paragraph (d)(1) of this section does not apply;

(6) None of the shareholders or partners in the entities described in the examples are related persons;

(7) All transactions described in each example occur pursuant to the same plan; and

(8) No property is acquired with a principal purpose of avoiding the purposes of section 7874.

Example 1. Stock transferred in exchange for marketable securities. (i) *Facts*. Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (i)(6) of this section) to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Then Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock.

(ii) *Analysis*. Under paragraphs (i)(6) and (i)(7)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not 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 marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is the FA stock transferred to Individual A in exchange for the 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 2. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874. (i) *Facts*. Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (i)(6) of this section) to FT, a newly formed corporation, in exchange solely for all the FT stock. Then PRS transfers the FT stock to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Finally, Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock. FA acquires the FT stock with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis*. Under paragraph (i)(7)(iv) of this section, the FT stock constitutes nonqualified property because a principal purpose of FA acquiring the FT stock is to avoid the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the FT stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not 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 FT stock increases the fair market value of FA's assets by the fair market value of the FT stock. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is FA stock transferred to Individual A in exchange for the 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 3. Stock transferred in exchange for stock of a foreign corporation that becomes a member of the expanded affiliated group. (i) *Facts*. FT, a publicly traded corporation, forms FA, and then FA forms DMS and FMS. FMS merges with and into FT, with FT surviving the merger (FMS-FT merger). Pursuant to the FMS-FT merger, the FT shareholders exchange their FT stock solely for 1,000 shares of FA stock and FT becomes a wholly owned subsidiary of FA. Following the FMS-FT merger, DMS merges with and into DT, also a publicly traded corporation, with DT surviving the merger (DMS-DT merger). Pursuant to the DMS-DT merger, the DT shareholders exchange their DT stock solely for the remaining 1,000 shares of FA stock, and DT becomes a wholly owned subsidiary of FA. After the completion of the plan, FA wholly owns FT and DT, DMS and FMS cease to exist, and the stock of FA is publicly traded.

(ii) *Analysis*. Because FT becomes a member of the expanded affiliated group that includes FA in a transaction related to FA's acquisition of substantially all the properties of DT, the FT stock does not constitute marketable securities (within the meaning of paragraph (i)(6) of this section) and therefore does not constitute nonqualified property pursuant to paragraph (i)(7)(ii) of this section. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and therefore the FA stock transferred in exchange for the FT stock and DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 1,000/2,000.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 3*, except that, instead of undertaking the FMS-FT merger, FT merges with and into FA with FA surviving the merger (FT-FA merger). Pursuant to the FT-FA merger, the FT shareholders exchange their FT stock solely for 1,000 shares of FA stock. At the time of the FT-FA merger, FT does not hold nonqualified property and has no obligations. Accordingly, FA stock transferred by FA to FT in exchange for the property of FT is not disqualified stock described in paragraph (c)(1) of this section. Furthermore, the 1,000 shares of FA stock transferred by FT to the shareholders of FT in exchange for their FT stock do not constitute disqualified stock described in paragraph (c)(1) of this section. Although the FT stock is nonqualified property (the FT stock constitutes marketable securities within the meaning of paragraph (i)(7)(ii) of this section because the stock of FT is publicly traded and FT is not a member of the expanded affiliated group that includes FA after the acquisition), under paragraph (c)(2) of this section, the transfer of FA stock by FT to the shareholders of FT neither increases the fair market value of the assets of FA nor decreases the liabilities of FA. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and, therefore, the FA stock transferred in exchange for the assets of FT and the DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 1,000/2,000.

Example 4. De minimis exception. (i) *Facts*. Individual A wholly owns DT. The fair market value of the DT stock is $100x. PRS transfers $96x of cash to FA, a newly formed corporation, in exchange solely for 96 shares of FA stock. Then Individual A transfers the DT stock to FA in exchange for $96x of cash and 4 shares of FA stock.

(ii) *Analysis*. Under paragraph (i)(7)(i) of this section, cash constitutes nonqualified property. Accordingly, the 96 shares of FA stock transferred by FA to PRS in exchange for $96x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section.

Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for $96x of cash increases the fair market value of the assets of FA by $96x. However, without regard to the application of 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 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). Furthermore, after the acquisition and all transactions related to the acquisition, Individual A owns less than 5% (by vote and value) of the stock of FA and DT (the members of the expanded affiliated group that includes FA). Accordingly, the *de minimis* exception in paragraph (d)(1) of this section applies and therefore paragraph (b) of this section does not apply to exclude the FA stock transferred to PRS from the denominator of the ownership fraction. Therefore, the FA stock transferred to Individual A and PRS is included in the denominator of the ownership fraction. Thus, the ownership fraction is 4/100.

Example 5. *Obligation of the expanded affiliated group satisfied with stock*. (i) *Facts*. Individual A wholly owns DT. The stock of DT held by Individual A has a fair market value of $75x. Individual A also holds an obligation of DT with a value and face amount of $25x. DT holds property with a value of $100x, and the $25x obligation is associated with the property. FA, a newly formed corporation, transfers 100 shares of FA stock to Individual A in exchange for all the DT stock and the $25x obligation of DT.

(ii) *Analysis*. Under paragraph (i)(7)(iii)(A) of this section, the $25x obligation of DT constitutes nonqualified property because DT is a member of the expanded affiliated group that includes FA. Thus, the shares of FA stock transferred by FA to Individual A in exchange for the obligation of DT constitute disqualified stock described in paragraph (c)(1)(i) of this section. Under § 1.7874–2(f)(2), Individual A is treated as receiving 75 shares of FA stock in exchange for the DT stock (100 x $75x/$100x) and 25 shares of FA stock in exchange for the obligation of DT (100 x $25x/$100x). Thus, 25 shares of FA stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock for the $25x obligation increases the fair market value of FA's assets by $25x. Therefore, under paragraph (b) of this section, the 25 shares of FA stock transferred to Individual A in exchange for the obligation of DT are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is the 75 shares of FA stock transferred to Individual A in exchange for the 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.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 5*, except that instead of acquiring the stock of DT and the $25x obligation of DT, FA acquires the $100x of property from DT in exchange solely for 100 shares of FA stock. DT distributes 75 shares of FA stock to Individual A in exchange for Individual A's DT stock and transfers 25 shares of FA stock to Individual A in satisfaction of DT's obligation to Individual A, and liquidates. The 25 shares of FA stock used to satisfy DT's obligation to Individual A after being transferred by FA to DT in exchange for the property of DT constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(ii) of this section because the transfer of FA stock in exchange for the property of DT increases the fair market value of FA's assets by $100x (although the amount of disqualified stock is limited to 25 shares of FA stock in this case). Therefore, under paragraph (b) of this section, the 25 shares of FA stock that constitute disqualified stock are not included in the denominator of the ownership fraction. Accordingly, only 75 shares of FA stock are included in the ownership fraction, 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 6. *"Over-the-top" stock transfer*. (i) *Facts*. Individual A wholly owns DT. Individual B holds all 100 outstanding shares of FA stock. Individual C acquires 20 shares of FA stock from Individual B for cash, and then FA acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock.

(ii) *Analysis*. Under paragraph (i)(7)(i) of this section, cash constitutes nonqualified property. Accordingly, absent the application of paragraph (c)(2) of this section, the 20 shares of FA stock transferred by Individual B to Individual C in exchange for cash would constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Nevertheless, because Individual B's sale of FA stock neither increases the assets of FA nor decreases the liabilities of FA, such FA stock is not disqualified stock by reason of paragraph (c)(2) of this section. Accordingly, paragraph (b) of this section does not apply to Individual B's sale of the 20 shares of FA stock to Individual C, and that FA stock is included in the denominator of the ownership fraction. The 100 shares of FA stock received by Individual A are the only shares included in the numerator of the ownership fraction. Thus, the ownership fraction is 100/200.

Example 7. *Interaction with internal group restructuring rule*. (i) *Facts*. P holds 85 shares of DT stock. The remaining 15 shares of DT stock are held by Individual A. P and Individual A transfer their shares of DT stock to FA, a newly formed corporation, in exchange for 85 and 15 shares of FA stock, respectively, and PRS transfers $75x of cash to FA in exchange for the remaining 75 shares of FA stock.

(ii) *Analysis*. Under paragraph (i)(7)(i) of this section, cash constitutes nonqualified property. Accordingly, the 75 shares of FA stock transferred by FA to PRS in exchange for $75x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for $75x of cash increases the fair market value of the assets of FA by $75x. Therefore, under paragraph (b) of this section, the 75 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Although PRS's shares of FA stock are excluded from the denominator of the ownership fraction under paragraph (b) of this section, such shares of FA stock nonetheless are taken into account for purposes of determining whether P is a member of the expanded affiliated group that includes FA under paragraph (h) of this section. Because P holds 48.6% of the FA stock (85/175) after the acquisition, it is not a member of the expanded affiliated group that includes FA. In addition, the acquisition does not qualify as an internal group restructuring described in § 1.7874–1(c)(2) because P does not hold, directly or indirectly, 80% or more of the shares of FA stock (by vote and value) after the acquisition. Therefore, the FA stock held by P (along with the FA stock held by Individual A) is included in the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 100/100.

Example 8. *Interaction with loss of control rule*. (i) *Facts*. P wholly owns DT. P transfers all of its shares of DT stock to FA, a newly formed corporation, in exchange for 49 shares of FA stock, and R transfers marketable securities (within the meaning of paragraph (i)(6) of this section) to FA in exchange for the remaining 51 shares of FA stock.

(ii) *Analysis*. Under paragraphs (i)(6) and (i)(7)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the shares of FA stock transferred by FA to R in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not 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 marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, the shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although under paragraph (b) of this section R's shares of FA stock are excluded from the denominator of the ownership fraction, under paragraph (h) of this section such stock is taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), P is not a member of the expanded affiliated group that includes FA, and P's FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), R is a member of the expanded affiliated group that includes FA and, before taking into account § 1.7874–1(c), R's FA stock would be excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and § 1.7874–1(b). However, the acquisition results in a loss of control described in § 1.7874–1(c)(2) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of FA stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the FA stock held by R would be included in the denominator of the ownership fraction under § 1.7874–1(c)(1). Nevertheless, the FA stock held by R is excluded from the denominator of the ownership fraction under paragraphs (b) and (h) of this section. Thus, the ownership fraction is 49/49.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 8*, except that, in exchange for 51 shares of FA stock, R transfers marketable securities (within the meaning of paragraph (i)(6) of this section) with a value equal to that of 16 shares of FA stock and qualified property (within the meaning of paragraph (i)(7) of this section) with a value equal to that of 35 shares of FA stock. Accordingly, 16 of the 51 shares of FA stock transferred to R constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section, and 35 of such shares do not constitute disqualified stock. Paragraph (c)(2) of this section does not 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 marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, 16 of the 51 shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although 16 of the 51 shares of FA stock that are transferred to R are excluded from the denominator of the ownership fraction, under paragraph (h) of this section, all 51 of R's shares of FA stock are taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), it is not a member of the expanded affiliated group that includes FA, and its FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), it is a member of the expanded affiliated group that includes FA and, before taking into account § 1.7874–1(c), its FA stock is excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and § 1.7874–1(b). However, the acquisition results in a loss of control described in § 1.7874–1(c)(2) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of FA stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the 51 shares of FA stock held by R would be included in the denominator of the ownership fraction under § 1.7874–1(c)(1). Nevertheless, the 16 shares of FA stock that constitute disqualified stock are excluded from the denominator of the ownership fraction under paragraphs (b) and (h) of this section. In addition, the 35 shares of FA stock received by R that do not constitute disqualified stock are included in the denominator. Thus, the ownership fraction is 49/84.

(k) *Effective/applicability dates*—(1) *General rule*. Except to the extent provided in paragraph (k)(2) of this section, this section applies to acquisitions completed on or after September 17, 2009.

(2) *Transitional rules*. For acquisitions completed on or after September 17, 2009, but before January 16, 2014, except as provided in paragraph (k)(3) of this section, this section shall be applied with the following modifications:

(i) Nonqualified property does not include property described in paragraph (i)(7)(iii) of this section.

(ii) A transfer is limited to an issuance of stock of the foreign acquiring corporation.

(iii) The determination of whether stock of the foreign acquiring corporation is described in paragraph (c)(1) of this section is made without regard to paragraphs (c)(1)(ii), (c)(2), and (e) of this section.

(iv) Paragraphs (d) and (h) of this section do not apply.

(3) *Election*. A taxpayer may elect to apply paragraphs (a) through (j) of this section to acquisitions completed on or after September 17, 2009, but before January 16, 2014, if the taxpayer applies those paragraphs consistently to all acquisitions completed before such date. The election is made by applying paragraphs (a) through (j) of this section to all such acquisitions on a timely filed original return (including extensions) or an amended return filed no later than six months after January 16, 2014. A separate statement or form evidencing the election need not be filed.

(l) *Expiration date*. The applicability of this section expires on January 13, 2017.

Par. 4. Section 1.7874–5T is added to read as follows:

§ 1.7874–5T Effect of certain transfers of stock related to the acquisition (temporary).

(a) *General rule*. Stock of a foreign corporation that is described in section 7874(a)(2)(B)(ii) shall not cease to be so described as a result of any subsequent transfer of the stock by the former shareholder (within the meaning of § 1.7874–2(b)(2)) or former partner (within the meaning of § 1.7874–2(b)(3)) that received such stock, even if the subsequent transfer is related to the acquisition described in section 7874(a)(2)(B)(i).

(b) *Example*. The rule of this section is illustrated by the following example:

Example. (i) *Facts*. Individual A wholly owns DT, a domestic corporation. FA, a newly formed foreign corporation, acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock. Pursuant to a binding commitment that was entered into in connection with FA's acquisition of the DT stock, Individual A sells 25 shares of FA stock to B, an unrelated person, in exchange for cash. For federal income tax purposes, the form of the steps of the transaction is respected.

(ii) *Analysis*. Under § 1.7874–2(f)(1), the 100 shares of FA stock received by Individual A are stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874(a)(2)(B)(ii). Under paragraph (a) of this section, all 100 shares of FA stock retain their status as being described in section 7874(a)(2)(B)(ii), even though Individual A sells 25 of the 100 shares in connection with the acquisition described in section 7874(a)(2)(B)(i) pursuant to the binding commitment. Therefore, all 100 of the shares of FA stock are included in both the numerator and denominator of the ownership fraction (as defined in § 1.7874–4T(i)(9)).

(c) *Effective/applicability dates*. This section applies to acquisitions that are completed on or after January 16, 2014.

(d) *Expiration date*. The applicability of this section expires on January 13, 2017.

John Dalrymple
Deputy Commissioner for Services and Enforcement.

Approved December 30, 2013

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

(Filed by the Office of the Federal Register on January 16, 2014, 8:45 a.m., and published in the issue of the Federal register for January 17, 2014, 79 F.R. 3094)

Part IV. Items of General Interest

Notice of Proposed Rulemaking by cross-reference to temporary regulations.

Guidance for Determining Stock Ownership

REG–121534–12

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In the Rules and Regulations section of this issue of the **Bulletin**, the IRS and the Treasury Department are issuing temporary regulations that identify 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. The temporary regulations also provide guidance with respect to the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of a trade or business of a domestic partnership. These regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or of the trades or businesses of such domestic partnerships. The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

DATES: Comments and requests for a public hearing must be received by April 17, 2014.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–121534–12), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–121534–12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–121534–12).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David A. Levine, (202) 317-6937; concerning submissions of comments or requests for a public hearing, Oluwafunmilayo Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in the Rules and Regulations section of this issue of the **Bulletin** amend the Income Tax Regulations (26 CFR part 1) relating to section 7874 of the Internal Revenue Code. The temporary regulations identify certain stock of a foreign corporation that is not taken into account for purposes of calculating the ownership percentage described in section 7874(a)(2)(B)(ii), and also address the effect of certain transfers of stock of a foreign corporation that occur after the acquisition described in section 7874(a)(2)(B)(i). The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains these amendments.

Special Analyses

It has been determined that that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. Given the complexity and cost of a transaction to which these regulations may apply, the IRS and the Treasury Department anticipate that these regulations primarily will affect large domestic corporations and partnerships and their shareholders and partners. Although small entities could be shareholders or partners of a larger domestic corporation or partnership involved in a transaction affected by the regulations, the IRS and the Treasury Department do not anticipate the number of these shareholders or partners to be substantial. Pursuant to section 7805(f), these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are David A. Levine of the Office of Associate Chief Counsel (International) and Mary W. Lyons, formerly of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.7874–4 also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–5 also issued under 26 U.S.C. 7874(c)(6) and (g).

Par. 2. Section 1.7874–4 is added to read as follows:

§ 1.7874–4 Disregard of certain stock related to the acquisition.

[The text of proposed § 1.7874–4(a) through (k) is the same as the text of § 1.7874–4T(a) through (k) published elsewhere in this issue of the **Bulletin**].

Par. 3. Section 1.7874–5 is added to read as follows:

§ 1.7874–5 Effect of certain transfers of stock related to the acquisition.

[The text of proposed § 1.7874–5(a) through (c) is the same as the text of § 1.7874–5T(a) through (c) published elsewhere in this issue of the **Bulletin**].

John Dalrymple
Deputy Commissioner for Services and Enforcement.

Approved December 12, 2013

(Filed by the Office of the Federal Register on January 16, 2014, 8:45 a.m., and published in the issue of the Federal register for January 17, 2014, 79 F.R. 3145)

Notice of Proposed Rulemaking and Notice of Public Hearing

Disallowance of Partnership Loss Transfers, Mandatory Basis Adjustments, Basis Reduction in Stock of a Corporate Partner, Modification of Basis Allocation Rules for Substituted Basis Transactions, Miscellaneous Provisions

REG-144468-05

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: The proposed regulations provide guidance on certain provisions of the American Jobs Creation Act of 2004 and conform the regulations to statutory changes in the Taxpayer Relief Act of 1997. The proposed regulations also modify the basis allocation rules to prevent certain unintended consequences of the current basis allocation rules for substituted basis transactions. Finally, the proposed regulations provide additional guidance on allocations resulting from revaluations of partnership property. The proposed regulations affect partnerships and their partners. This document also contains a notice of a public hearing on these proposed regulations.

DATES: Comments must be received by April 16, 2014. Requests to speak and outlines of the topics to be discussed at the public hearing scheduled for April 30, 2014, at 10 a.m., must be received by April 16, 2014.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–144468–05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–144468–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–144468–05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Wendy Kribell or Benjamin Weaver at (202) 317-6850; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by March 17, 2014. Comments are specifically requested concerning:

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

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

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

The collections of information in the proposed regulations are in proposed §§ 1.704–3(f), 1.734–1(d), 1.743–1(k), and 1.743–1(n). This information will be used by the IRS to assure compliance with certain provisions of the American Jobs Creation Act of 2004. The collections of information are either required to obtain a benefit or are mandatory. The likely respondents are individuals and partnerships.

The burden for the collection of information in § 1.704–3(f) is as follows:

Estimated total annual reporting burden: 324,850 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 162,425.

Estimated annual frequency of responses: On occasion.

The burden for the collection of information in § 1.734–1(d) is as follows:

Estimated total annual reporting burden: 1,650 hours.

Estimated average annual burden per respondent: 3 hours.

Estimated number of respondents: 550.

Estimated annual frequency of responses: On occasion.

The burden for the collection of information in § 1.743–1(k)(1) is as follows:

Estimated total annual reporting burden: 1,650 hours.

Estimated average annual burden per respondent: 3 hours.

Estimated number of respondents: 550.

Estimated annual frequency of responses: On occasion.

The burden for the collection of information in § 1.743–1(k)(2) is as follows:

Estimated total annual reporting burden: 550 hours.

Estimated average annual burden per respondent: 1 hour.

Estimated number of respondents: 550.

Estimated annual frequency of responses: On occasion.

The burden for the collection of information in § 1.743–1(n)(10) is as follows:

Estimated total annual reporting burden: 3,600 hours.

Estimated average annual burden per respondent: 1 hour.

Estimated number of respondents: 3,600.

Estimated annual frequency of responses: Various.

The burden for the collection of information in § 1.743–1(n)(11) is as follows:

Estimated total annual reporting burden: 2,700 hours.

Estimated average annual burden per respondent: 1.5 hours.

Estimated number of respondents: 1,800.

Estimated annual frequency of responses: On occasion

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

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

Background

1. *Contributions of Built-in Loss Property*

Under section 721(a) of the Internal Revenue Code (the Code), if a partner contributes property in exchange for a partnership interest, neither the partners nor the partnership recognize gain or loss. Section 722 provides that when a partner contributes property to a partnership, the basis in the partnership interest received equals the adjusted basis of the contributed property. Similarly, under section 723, the partnership's adjusted basis in the contributed property equals the contributing partner's adjusted basis in the property. Section 704(c)(1)(A) requires the partnership to allocate items of partnership income, gain, loss, and deduction with respect to contributed property among the partners so as to take into account any built-in gain or built-in loss in the contributed property. This rule is intended to prevent the transfer of built-in gain or built-in loss from the contributing partner to other partners. If a partner contributes built-in gain or built-in loss property to a partnership and later transfers the interest in the partnership, § 1.704–3(a)(7) provides that the built-in gain or built-in loss must be allocated to the transferee as it would have been allocated to the transferor.

Section 833(a) of the American Jobs Creation Act of 2004, Public Law 108-357, 118 Stat. 1418 (the AJCA) added section 704(c)(1)(C) to the Code for contributions of built-in loss property to partnerships after October 22, 2004. In general, section 704(c)(1)(C) provides that a partner's built-in loss may only be taken into account in determining the contributing partner's share of partnership items. Prior to the AJCA, a contributing partner could transfer losses to a transferee partner or other partners when the contributing partner was no longer a partner in the partnership. *See* H. R. Rep. 108–548 at 282 (2004) (House Committee Report) and H.R. Rep. 108–755 at 622 (2004) (Conference Report). Thus, Congress enacted section 704(c)(1)(C) to prevent the inappropriate transfer of built-in losses to partners other than the contributing partner. *See* House Committee Report, at 283. More specifically, Congress enacted section 704(c)(1)(C) to prevent a transferee partner from receiving an allocation of the transferor partner's share of losses relating to the transferor's contribution of built-in loss property and to prevent remaining partners from receiving an allocation of a distributee partner's share of losses relating to the distributee's contribution of built-in loss property when the distributee receives a liquidating distribution. *See* House Committee Report, at 282 and Conference Report, at 621–622. To that end, section 704(c)(1)(C) provides that if property contributed to a partnership has a built-in loss, (i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner; and (ii) except as provided by regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is equal to its fair market value at the time of the contribution. For purposes of section 704(c)(1)(C), the term *built-in loss* means the excess of the adjusted basis of the property (determined without regard to section 704(c)(1)(C)(ii)) over its fair market value at the time of contribution.

2. *Mandatory Basis Adjustment Provisions*

a. *Overview*

The mandatory basis adjustment provisions in section 833(b) and (c) of the AJCA reflect Congress' belief that the "electivity of partnership basis adjustments upon transfers and distributions leads to anomalous tax results, causes inaccurate income measurement, and gives rise to opportunities for tax sheltering." *See* S. Rep. 108-192 at 189 (2003) (Grassley Report). Specifically, Congress was concerned that the optional basis adjustment regime permitted partners to duplicate losses and inappropriately transfer losses among partners. *Id*. According to the legislative history, Congress intended these amendments to prevent the inappropriate transfer of losses among partners, while preserving the simplification aspects of the existing partnership rules for transactions involving smaller amounts (as described in this preamble, a $250,000 threshold). *See* House Committee Report, at 283. Thus, section 743 and section 734 were amended as described in sections 2.b. and 2.c. of the background section of this preamble.

b. *Section 743 substantial built-in loss provisions*

i. *In general*

Before the enactment of the AJCA, under section 743(a), upon the transfer of a partnership interest by sale or exchange or upon the death of a partner, a partnership was not required to adjust the basis of partnership property unless the partnership had a section 754 election in effect. If the partnership had a section 754 election in effect at the time of a transfer, section 743(b) required the partnership to increase or decrease the adjusted basis of the partnership property to take into account the difference between the transferee's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.

As amended by the AJCA, section 743(a) and (b) require a partnership to adjust the basis of partnership property upon a sale or exchange of an interest in the partnership or upon the death of a partner if there is a section 754 election in effect, or, for transfers after October 22, 2004, if the partnership has a substantial built-in loss immediately after the transfer (regardless of whether the partnership has a section 754 election in effect). Section 743(d)(1) provides that, for purposes of section 743, a partnership has a substantial built-in loss if the partnership's adjusted basis in the partnership property exceeds the fair market value of the property by more than $250,000. Section 743(d)(2) provides that the Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of section 743(d)(1), including regulations aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes.

ii. *Electing investment partnerships*

Section 833(b) of the AJCA also added section 743(e) to the Code, which provides alternative rules for electing investment partnerships (EIPs). According to the legislative history, Congress was aware that mandating section 743(b) adjustments would impose administrative difficulties on certain types of investment partnerships that are engaged in investment activities and that typically did not make section 754 elections prior to the AJCA, even when the adjustments to the bases of partnership property would be upward adjustments. *See* House Committee Report, at 283. Accordingly, for partnerships that meet the requirements of an EIP in section 743(e)(6) and that elect to apply the provisions of section 743(e), section 743(e)(1) provides that for purposes of section 743, an EIP shall not be treated as having a substantial built-in loss with respect to any transfer occurring while the EIP election is in effect. Instead, section 743(e)(2) provides that, in the case of a transfer of an interest in an EIP, the transferee's distributive share of losses (without regard to gains) from the sale or exchange of partnership property shall not be allowed except to the extent that it is established that such losses exceed the loss (if any) recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under section 743(e)(2)) on the transfer of the partnership interest. Section 743(e)(3) further provides that losses disallowed under section 743(e)(2) shall not decrease the transferee's basis in the partnership interest. In the case of partnership property that has a built-in loss at the time of the transfer, the loss disallowance rules in section 743(e)(2) and (e)(3) approximate the effect of a basis adjustment and prevent the transferee from taking into account an allocation of the preexisting built-in loss (and the corresponding basis reduction) without requiring the partnership to adjust the bases of all partnership property. In addition, section 743(e)(5) provides that in the case of a transferee whose basis in distributed partnership property is reduced under section 732(a)(2), the amount of the loss recognized by the transferor on the transfer that is taken into account under section 743(e)(2) shall be reduced by the amount of such basis reduction.

Section 743(e)(6) defines an *electing investment partnership* as any partnership if (A) the partnership makes an election to have section 743(e) apply; (B) the partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of section 3(c) of the Act; (C) the partnership has never been engaged in a trade or business; (D) substantially all of the assets of the partnership are held for investment; (E) at least 95 percent of the assets contributed to the partnership consist of money; (F) no assets contributed to the partnership had an adjusted basis in excess of fair market value at the time of contribution; (G) all partnership interests are issued pursuant to a private offering before the date that is 24 months after the date of the first capital contribution to the partnership; (H) the partnership agreement has substantive restrictions on each partner's ability to cause a redemption of the partner's interest; and (I) the partnership agreement provides for a term that is not in excess of 15 years. The flush language of section 743(e)(6) provides that the EIP election, once made, shall be irrevocable except with the consent of the Secretary. Section 833(d) of the AJCA provides a transition rule with respect to section 743(e)(6)(H) and (I) for partnerships eligible to make an election to be an EIP that were in existence on June 4, 2004. For those partnerships, section 743(e)(6)(H) does not apply and the term in section 743(e)(6)(I) is 20 years.

According to the legislative history, Congress expected EIPs to include venture capital funds, buyout funds, and funds of funds. *See* Conference Report, at 626. The legislative history further indicates that, with respect to the requirement in section 743(e)(6)(G), Congress intended that "dry" closings in which partnership interests are issued without the contribution of capital not start the running of the 24-month period. *Id*. Furthermore, with respect to the requirement in section 743(e)(6)(H), Congress provided illustrative examples of substantive restrictions: a violation of Federal or State law (such as ERISA or the Bank Holding Company Act) or an imposition of the

Federal excise tax on, or a change in the Federal tax-exempt status of, a tax-exempt partner. *Id*.

Section 743(e)(4) also provides that section 743(e) shall be applied without regard to any termination of a partnership under section 708(b)(1)(B). Finally, section 743(e)(7) provides that the Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of section 743(e), including regulations for applying section 743(e) to tiered partnerships.

Section 833(b) of the AJCA prescribed certain reporting requirements for EIPs by adding section 6031(f) to the Code. Section 6031(f) provides that in the case of an EIP, the information required under section 6031(b) (relating to furnishing copies of returns of partnership income to partners) to be furnished to a partner to whom section 743(e)(2) applies shall include information as is necessary to enable the partner to compute the amount of losses disallowed under section 743(e).

On April 1, 2005, the Treasury Department and the IRS issued Notice 2005–32 (2005–1 CB 895), which provides, in part, interim procedures and reporting requirements for EIPs; interim procedures for transferors of EIP interests; and guidance regarding whether a partnership is engaged in a trade or business for purposes of section 743(e)(6)(C). Public comments on Notice 2005–32 are discussed in Parts 2.a.i and 2.a.ii of the Explanation of Provisions section of this preamble. *See* § 601.601(d)(2)(ii)(b).

iii. *Securitization partnerships*

Finally, section 833 of the AJCA added section 743(f) to the Code, which provides an exception from the mandatory basis adjustment provisions in section 743(a) and (b) for securitization partnerships. Section 743(f)(1) states that for purposes of section 743, a securitization partnership shall not be treated as having a substantial built-in loss with respect to any transfer. Section 743(f)(2) provides that the term *securitization partnership* means a partnership the sole business activity of which is to issue securities that provide for a fixed principal (or similar) amount and that are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets that by their terms convert into cash in a finite period, but only if the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired so as to be disposed of. For purposes of the "reasonable belief" standard, the legislative history indicates that Congress intended rules similar to the rules in § 1.860G–2(a)(3) (relating to a reasonable belief safe harbor for obligations principally secured by an interest in real property) to apply. *See* Conference Report, at 627. Furthermore, Congress did not intend for the mandatory basis adjustment rules to be avoided by securitization partnerships through dispositions of pool assets. *Id*. Finally, the legislative history states that if a partnership ceases to meet the qualifications of a securitization partnership, the mandatory basis adjustment provisions apply to the first transfer thereafter and to each subsequent transfer. *Id*.

c. *Section 734 substantial basis reduction provisions*

Section 734(b) requires a partnership to increase or decrease the adjusted basis of partnership property to take into account any gain or loss recognized to the distributee and the difference between the partnership's and the distributee's bases in distributed property. Similar to section 743, prior to the AJCA, section 734(a) did not require a partnership to adjust the basis of partnership property upon a distribution of partnership property to a partner unless the partnership had a section 754 election in effect.

Consistent with the amendments to section 743, section 833(c) of the AJCA amended section 734(a) and (b) to require a partnership to adjust the basis of partnership property upon a distribution of partnership property to a partner if there is a section 754 election in effect or, for distributions occurring after October 22, 2004, if there is a substantial basis reduction with respect to the distribution. Section 734(d)(1) provides that for purposes of section 734, there is a substantial basis reduction with respect to a distribution if the sum of the amounts described in section 734(b)(2)(A) and 734(b)(2)(B) exceeds $250,000. The amount described in section 734(b)(2)(A) is the amount of loss recognized to the distributee partner with respect to the distribution under section 731(a)(2). The amount described in section 734(b)(2)(B) is, in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)). Section 734(d)(2) provides regulatory authority for the Secretary to carry out the purposes of section 734(d) by cross-reference to section 743(d)(2). Section 743(d)(2) is discussed in Part 2.b.i of the Background section of this preamble.

As with section 743(b) adjustments, section 734(e) provides an exception to the mandatory basis adjustment provisions in section 734 for securitization partnerships. A securitization partnership (which is defined by reference to section 743(f)) is not treated as having a substantial basis reduction with respect to any distribution of property to a partner. *See* Part 2.b.iii of the Background section of this preamble for the definition of securitization partnership in section 743(f). Like the rules under section 743, the mandatory basis adjustment provisions under section 734 will apply with respect to the first distribution that occurs after the partnership ceases to meet the definition of a securitization partnership and to each subsequent distribution.

d. *Interim reporting requirements for mandatory basis adjustments*

The Treasury Department and the IRS issued general interim procedures for mandatory basis adjustments under sections 734 and 743. These interim procedures, which are described in Notice 2005–32, state that until further guidance is provided, partnerships required to reduce the bases of partnership properties under the substantial basis reduction provisions in section 734 must comply with § 1.734–1(d) as if an election under section 754 were in effect at the time of the relevant distribution. Similarly, partnerships that are required to reduce the bases of partnership properties under the substantial built-in loss provisions in section

743 must comply with § 1.743–1(k)(1), (3), (4), and (5) as if an election under section 754 were in effect at the time of the relevant transfer. Furthermore, a transferee of an interest in a partnership that is required to reduce the bases of partnership properties under the substantial built-in loss provisions must comply with § 1.743–1(k)(2) as if an election under section 754 were in effect at the time of the relevant transfer.

3. *Section 755 Rules for Allocation of Basis*

a. *Section 755(c)*

If section 734(a) requires a basis adjustment (either because the partnership has a section 754 election in effect or because there is a substantial basis reduction with respect to the distribution), section 734(b) provides that the partnership increases or decreases the basis of partnership property by any gain or loss recognized by the distributee and the difference (if any) between the partnership's and the distributee's adjusted bases in the distributed property. Section 755(a) generally provides that any increase or decrease in the adjusted basis of partnership property under section 734(b) shall be allocated in a manner that: (1) reduces the difference between the fair market value and the adjusted basis of partnership properties, or (2) in any other manner permitted by regulations. Generally, section 755(b) requires a partnership to allocate increases or decreases in the adjusted basis of partnership property arising from the distribution of property to property of a like character to the property distributed (either to (1) capital assets and property described in section 1231(b), or (2) any other property).

According to the Joint Committee on Taxation's (the JCT's) investigative report of Enron Corporation (*See* Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, JCS-3-03 (February 2003) (JCT Enron Report)), taxpayers were engaging in transactions to achieve unintended tax results through the interaction of these partnership basis adjustment rules and the rules in section 1032 protecting a corporation from recognizing gain on its stock. Section 1032(a) provides that no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of the corporation. In particular, the JCT Enron Report describes Enron Corporation's Project Condor as structured to take advantage of the interaction between sections 754 and 1032 by increasing the basis of depreciable assets under section 732 while decreasing the basis under section 734(b) of preferred stock of a corporate partner held by the partnership. The step down in the basis of the corporate partner's preferred stock had no ultimate tax effect because the corporate partner could avoid recognizing the gain in the stock through section 1032, which prevents a corporation from recognizing gain on the sale of its stock. The transaction thus duplicated tax deductions at no economic cost. *See* Grassley Report, at 127 and House Committee Report, at 287. The JCT expressed specific concern about the exclusion of gain under section 1032 following a negative basis adjustment under section 734(b) to stock of a corporate partner. JCT Enron Report, at 220–21. Therefore, the JCT recommended that the partnership basis rules preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner (or related party). *Id*. at 221.

In response to these recommendations, section 834(a) of the AJCA enacted section 755(c), which provides that in making an allocation under section 755(a) of any decrease in the adjusted basis of partnership property under section 734(b)–(1) no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) and 707(b)(1)) to such corporation) that is a partner in the partnership, and (2) any amount not allocable to stock by reason of section 755(c)(1) shall be allocated under section 755(a) to other partnership property. The flush language of section 755(c) further provides that a partnership recognizes gain to the extent that the amount required to be allocated under section 755(c)(2) to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the required allocation.

b. *Basis adjustment allocation rules for substituted basis transactions*

A basis adjustment under section 743(a) is determined in accordance with section 743(b). The partnership must allocate any increase or decrease in the adjusted basis of partnership property required under section 743(b) under the rules of section 755. Section 1.755–1(b)(5) provides additional guidance on how to allocate basis adjustments under section 743(b) that result from substituted basis transactions, which are defined as exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest. For exchanges on or after June 9, 2003, § 1.755–1(b)(5) also applies to basis adjustments that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee.

Generally, § 1.755–1(b)(5)(ii) provides that if there is an increase in basis to be allocated to partnership assets, the increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. Similarly, if there is a decrease in basis to be allocated to partnership assets, § 1.755–1(b)(5)(ii) generally provides that the decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Thus, whether or not a basis adjustment resulting from a substituted basis transaction can be allocated to partnership property depends on whether the transferee partner would be allocated a net gain or net income, in the case of a positive basis adjustment, or net loss, in the case of a negative basis adjustment.

Section 1.755–1(b)(5)(iii) provides rules for allocating increases or decreases in basis within the classes of property. Of note, in the case of a decrease, § 1.755–1(b)(5)(iii)(B) states that the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before the decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence) (subject to a limitation in decrease of basis in § 1.755–1(b)(5)(iii)(C) and a carryover rule in § 1.755–1(b)(5)(iii)(D)).

In addition, § 1.743–1(f) provides that, when there has been more than one transfer of a partnership interest, a partnership determines a transferee's basis adjustment without regard to any prior transferee's basis adjustment. Accordingly, if a partner acquires its partnership interest in a transaction other than a substituted basis transaction and then subsequently transfers its interest in a substituted basis transaction, the transferee's basis adjustment may shift among partnership assets.

4. *Miscellaneous Provisions*

a. *Section 704(c) allocations*

Property contributed to a partnership by a partner is section 704(c) property if, at the time of contribution, the property has a built-in gain or built-in loss ("forward section 704(c) gain or loss"). Section 704(c)(1)(A) requires a partnership to allocate income, gain, loss, and deduction so as to take into account the built-in gain or built-in loss. For this purpose, § 1.704–3(a)(3)(ii) provides that a built-in gain or built-in loss is generally the difference between the property's book value and the contributing partner's adjusted tax basis upon contribution (reduced by decreases in the difference between the property's book value and adjusted tax basis). Section 1.704–3(a)(6)(i) provides that the principles of section 704(c) also apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to § 1.704–1(b)(2)(iv)(*f*) or § 1.704–1(b)(2)(iv)(*s*) ("reverse section 704(c) allocations"). Partnerships are not required to use the same allocation method for forward and reverse section 704(c) allocations, but the allocation method (or combination of methods) must be reasonable. *See* §§ 1.704–3(a)(6)(i) and 1.704–3(a)(10)(i). Section 1.704–3(a)(10)(i) provides that an allocation method is not reasonable if the contribution or revaluation event and the corresponding allocation are made with a view to shifting the tax consequences of built-in gain or built-in loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

On August 12, 2009, the Treasury Department and the IRS published Notice 2009–70, 2009–2 CB 255, which requested comments on the proper application of the rules relating to the creation and maintenance of forward and multiple reverse section 704(c) allocations (referred to as "section 704(c) layers" in this preamble). Specifically, Notice 2009–70 requested comments on, among other things, whether taxpayers should net reverse section 704(c) allocations against existing section 704(c) layers or maintain separate section 704(c) layers; if the section 704(c) layers offset one another; how partnerships should allocate tax depreciation, depletion, amortization, and gain or loss between multiple section 704(c) layers (including any offsetting section 704(c) layers); and whether there are other issues relating to section 704(c) layers. Public comments on Notice 2009–70 are discussed in Part 4.a of the Explanation of Provisions section of this preamble. *See* § 601.601(d)(2)(ii)(b).

b. *Extension of time period for taxing precontribution gain*

The Taxpayer Relief Act of 1997 (Pub. Law 105–34, 111 Stat. 788) extended the time period in sections 704(c)(1)(B) and 737(b)(1) for taxing precontribution gain for property contributed to a partnership after June 8, 1997, from five years to seven years (the rule does not, however, apply to any property contributed pursuant to a written binding contract in effect on June 8, 1997, and at all times thereafter before such contribution if such contract provides for the contribution of a fixed amount of property). The regulations under sections 704, 737, and 1502 have not been revised to reflect this statutory change.

Explanation of Provisions

1. *Contributions of Built-in Loss Property*

a. *Overview*

Section 704(c)(1)(C)(i) provides that if property contributed to a partnership has a built-in loss ("section 704(c)(1)(C) property"), such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner ("section 704(c)(1)(C) partner"). Section 704(c)(1)(C)(ii) further provides that, except as provided by regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is equal to its fair market value at the time of the contribution. For purposes of section 704(c)(1)(C), the term *built-in loss* means the excess of the adjusted basis of the section 704(c)(1)(C) property (determined without regard to section 704(c)(1)(C)(ii)) over its fair market value at the time of contribution.

The Treasury Department and the IRS believe additional guidance is needed with respect to the application of section 704(c)(1)(C). Accordingly, the proposed regulations provide rules regarding: (1) the scope of section 704(c)(1)(C); (2) the effect of the built-in loss; (3) distributions by partnerships holding section 704(c)(1)(C) property; (4) transfers of a section 704(c)(1)(C) partner's partnership interest; (5) transfers of section 704(c)(1)(C) property; and (6) reporting requirements.

b. *Scope of section 704(c)(1)(C)*

The proposed regulations define section 704(c)(1)(C) property as section 704(c) property with a built-in loss at the time of contribution. Thus, in addition to the rules in the proposed regulations, section 704(c)(1)(C) property is subject to the existing rules and regulations applicable to section 704(c) property generally (see, for example, § 1.704–3(a)(9), which provides special rules for tiered partnerships), except as provided in the proposed regulations.

The Treasury Department and the IRS considered whether the principles of section 704(c)(1)(C) should apply to reverse section 704(c) allocations (within the meaning of § 1.704–3(a)(6)(i)). The Treasury Department and the IRS concluded that applying the proposed regulations to reverse section 704(c) allocations would be difficult for taxpayers to comply with and for the IRS to administer. Therefore, the proposed regulations do not apply to reverse section 704(c) allocations.

The Treasury Department and the IRS also considered whether section 704(c)(1)(C) should apply to § 1.752–7 liabilities. Under § 1.752–7(b)(3)(i), a § 1.752–7 liability is an obligation described in § 1.752–1(a)(4)(ii) (generally any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of Code) to the extent that the obligation either is not described in § 1.752–1(a)(4)(i) or the amount of the obligation exceeds the amount taken into account under § 1.752–1(a)(4)(i). The preamble to the final regulations under § 1.752–7, published on May 26, 2005, acknowledges that the rules in section 704(c)(1)(C) and the rules under § 1.752–7 are similar. *See* TD 9207, 70 FR 30334. The preamble explains that it is possible to view the contribution of property with an adjusted tax basis equal to the fair market value of the property, determined without regard to any § 1.752–7 liabilities, as built-in loss property after the § 1.752–7 liability is taken into account (when the § 1.752–7 liability is related to the contributed property). However, the preamble further provides that § 1.752–7 shall be applied without regard to the amendments made by the AJCA, unless future guidance provides to the contrary. The Treasury Department and the IRS believe the rules regarding § 1.752–7 liabilities adequately address the issues posed by § 1.752–7 liabilities and, thus, the proposed regulations provide that section 704(c)(1)(C) property does not include a § 1.752–7 liability.

c. *Effect of section 704(c)(1)(C) basis adjustment*

The legislative history indicates that Congress intended the built-in loss attributable to section 704(c)(1)(C) property to be for the benefit of the contributing partner only. Conceptually, the built-in loss is similar to a section 743(b) adjustment, which is an adjustment to the basis of partnership property solely with respect to the transferee partner. The current regulations under section 743 provide detailed rules regarding accounting for, maintenance of, recovery of, and transfers of assets with, section 743(b) adjustments. The Treasury Department and the IRS believe it is appropriate that the proposed regulations provide rules similar to those applicable to positive basis adjustments under section 743(b). The Treasury Department and the IRS believe that this approach simplifies the application and administration of section 704(c)(1)(C) and provides a framework of rules familiar to partners, partnerships, and the IRS. Even though the proposed regulations generally adopt the approach taken with respect to section 743(b) adjustments, the Treasury Department and the IRS believe that some of the rules governing section 743(b) adjustments should not apply with respect to a built-in loss and that additional rules are necessary for section 704(c)(1)(C). Thus, the proposed regulations import and specifically apply certain concepts contained in the section 743 regulations to section 704(c)(1)(C), as opposed to simply providing that principles similar to those contained in the regulations under section 743 apply to section 704(c)(1)(C) by cross-reference. The following discussion describes both the substantive rules applied under section 704(c)(1)(C) and, where applicable, how those rules differ from their counterparts under section 743(b).

The proposed regulations create the concept of a section 704(c)(1)(C) basis adjustment. The section 704(c)(1)(C) basis adjustment is initially equal to the built-in loss associated with the section 704(c)(1)(C) property at the contribution and then is adjusted in accordance with the proposed regulations. For example, if A contributes, in a section 721 transaction, property with a fair market value of $6,000 and an adjusted basis of $11,000 to a partnership, the partnership's basis in the property is $6,000, A's basis in its partnership interest is $11,000, and A has a section 704(c)(1)(C) basis adjustment of $5,000. Similar to basis adjustments under section 743(b), a section 704(c)(1)(C) basis adjustment is unique to the section 704(c)(1)(C) partner and does not affect the basis of partnership property or the partnership's computation of any item under section 703. The rules regarding the effect of the section 704(c)(1)(C) basis adjustment are similar to the rules for section 743(b) adjustments in §§ 1.743–1(j)(1) through (j)(3), including: (1) the effect of the section 704(c)(1)(C) basis adjustment on the basis of partnership property; (2) the computation and allocation of the partnership's items of income, deduction, gain, or loss; (3) adjustments to the partners' capital accounts; (4) adjustments to the section 704(c)(1)(C) partner's distributive share; and (5) the determination of a section 704(c)(1)(C) partner's income, gain, or loss from the sale or exchange of section 704(c)(1)(C) property. The Treasury Department and the IRS believe the rule regarding recovery of the section 704(c)(1)(C) basis adjustment should be consistent with the rule regarding recovery of the adjusted tax basis in the property that is not subject to section 704(c)(1)(C). Thus, for property eligible for cost recovery, the proposed regulations provide that, regarding the effect of the basis adjustment in determining items of deduction, if section 704(c)(1)(C) property is subject to amortization under section 197, depreciation under section 168, or other cost recovery in the hands of the section 704(c)(1)(C) partner, the section 704(c)(1)(C) basis adjustment associated with the property is recovered in accordance with section 197(f)(2), section 168(i)(7), or other applicable Code sections. Similar to section 743, the proposed regulations further provide that the amount of any section 704(c)(1)(C) basis adjustment that is recovered by the section 704(c)(1)(C) partner in any year is added to the section 704(c)(1)(C) partner's distributive share of the partnership's depreciation or amortization deductions for the year. The section 704(c)(1)(C) basis adjustment is adjusted under section 1016(a)(2) to reflect the recovery of the section 704(c)(1)(C) basis adjustment.

d. *Distribution by partnership holding section 704(c)(1)(C) property*

The proposed regulations provide guidance on current distributions of section 704(c)(1)(C) property to the section 704(c)(1)(C) partner; distributions of section 704(c)(1)(C) property to another partner; and liquidating distributions to a section 704(c)(1)(C) partner. The Treasury Department and the IRS believe it is appropriate to apply principles similar to section 743 to simplify the administration of section 704(c)(1)(C) for partners, partnerships, and the IRS. Thus, the proposed regulations generally provide rules similar to those for section 743(b) adjustments.

i. *Current distribution of section 704(c)(1)(C) property to section 704(c)(1)(C) partner*

Under the proposed regulations, the adjusted partnership basis of section 704(c)(1)(C) property distributed to the section 704(c)(1)(C) partner includes the section 704(c)(1)(C) basis adjustment for purposes of determining the amount of any adjustment under section 734. However, the proposed regulations provide that section 704(c)(1)(C) basis adjustments are not taken into account in making allocations under § 1.755–1(c).

ii. *Distribution of section 704(c)(1)(C) property to another partner*

Under the proposed regulations, if a partner receives a distribution of property in which another partner has a section 704(c)(1)(C) basis adjustment, the distributee partner does not take the section 704(c)(1)(C) basis adjustment into account under section 732. However, the Treasury Department and the IRS request comments on whether a section 704(c)(1)(C) adjustment to distributed stock should be taken into account for purposes of section 732(f) notwithstanding the general rule that section 704(c)(1)(C) adjustments are not taken into account under section 732.

Upon the distribution of section 704(c)(1)(C) property to another partner, the section 704(c)(1)(C) partner reallocates its section 704(c)(1)(C) basis adjustment relating to the distributed property among the remaining items of partnership property under § 1.755–1(c), which is similar to the rule in § 1.743–1(g)(2)(ii) for reallocating section 743(b) adjustments. This rule allocates the basis adjustment to partnership property without regard to the section 704(c)(1)(C) partner's allocable share of income, gain, or loss in each partnership asset. The Treasury Department and the IRS request comments on whether the reallocations of section 704(c)(1)(C) basis adjustments and section 743(b) basis adjustments should instead be made under the principles of § 1.755–1(b)(5)(iii) to take into account the partner's allocable share of income, gain, or loss from each partnership asset.

The proposed regulations further provide that if section 704(c)(1)(B) applies to treat the section 704(c)(1)(C) partner as recognizing loss on the sale of the distributed property, the section 704(c)(1)(C) basis adjustment is taken into account in determining the amount of loss. Accordingly, when the section 704(c)(1)(C) property is distributed to a partner other than the contributing partner within seven years of its contribution to the partnership, the loss will be taken into account by the contributing partner. The Treasury Department and the IRS considered extending the seven-year period so that the loss will be taken into account by the contributing partner on any distribution of section 704(c)(1)(C) property to a partner other than the contributing partner. The Treasury Department and the IRS do not adopt this approach in the proposed regulations because it would be inconsistent with section 704(c)(1)(B) generally and would be more difficult to administer.

iii. *Distribution in complete liquidation of a section 704(c)(1)(C) partner's interest*

The proposed regulations provide that if a section 704(c)(1)(C) partner receives a distribution of property (whether or not the property is section 704(c)(1)(C) property) in liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment for the property in which the section 704(c)(1)(C) partner relinquished an interest (if any) by reason of the liquidation. For purposes of determining the redeemed section 704(c)(1)(C) partner's basis in distributed property under section 732, the partnership reallocates any section 704(c)(1)(C) basis adjustment from section 704(c)(1)(C) property retained by the partnership to distributed properties of like character under the principles of § 1.755–1(c)(i), after applying sections 704(c)(1)(B) and 737. If section 704(c)(1)(C) property is retained by the partnership, and no property of like character is distributed, then that property's section 704(c)(1)(C) basis adjustment is not reallocated to the distributed property for purposes of applying section 732.

If any section 704(c)(1)(C) basis adjustment is not reallocated to the distributed property in connection with the distribution, then that remaining section 704(c)(1)(C) basis adjustment shall be treated as a positive section 734(b) adjustment. If the distribution also gives rise to a negative section 734(b) adjustment, then the negative section 734(b) adjustment and the section 704(c)(1)(C) basis adjustment reallocation are netted together, and the net amount is allocated under § 1.755–1(c). If the partnership does not have a section 754 election in effect at the time of the liquidating distribution, the partnership shall be treated as having made a section 754 election solely for purposes of computing any negative section 734(b) adjustment that would arise from the distribution.

e. *Transfer of section 704(c)(1)(C) partner's partnership interest*

i. *In general*

Under section 722, a section 704(c)(1)(C) partner's basis in its partnership interest fully reflects the built-in loss portion of the basis of the contributed property and the built-in loss generally is taken into account by the section 704(c)(1)(C) partner upon disposition of the partnership interest. Therefore, in accordance with section 704(c)(1)(C)'s overall policy objective of preventing the inappropriate transfer of built-in losses through partnerships, the proposed regulations provide that the transferee of a section 704(c)(1)(C) partner's partnership interest generally does not succeed to the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment. Instead, the share of the section 704(c)(1)(C) basis adjustment attributable to the interest transferred is eliminated. For example, if a section 704(c)(1)(C) partner sells 20 percent of its interest in a partnership, the partner recognizes its outside loss with respect to that 20 percent but 20 percent of the partner's section 704(c)(1)(C) basis adjustment for each section 704(c)(1)(C) property contributed by the partner is eliminated. The transferor remains a section 704(c)(1)(C) partner with respect to any remaining section 704(c)(1)(C) basis adjustments. The proposed regulations provide exceptions to this general rule for nonrecognition transactions, which are discussed in Part 1.e.ii of the Explanation of Provisions section of this preamble.

ii. *Nonrecognition transactions*

Under the proposed regulations, the general rule that a section 704(c)(1)(C) basis adjustment is not transferred with the related partnership interest does not apply to the extent a section 704(c)(1)(C) partner transfers its partnership interest in a nonrecognition transaction, with certain exceptions. The legislative history notes that Congress intended to treat a corporation succeeding to the attributes of a contributing corporate partner under section 381 in the same manner as the contributing partner. *See* Conference Report, at 623 n. 546. The Treasury Department and the IRS considered whether similar successor rules should apply in other nonrecognition transactions. Some of the considerations included: (1) providing consistent results regardless of the order in which a transaction occurs; (2) ensuring that built-in losses are not duplicated; (3) preventing the shifting of basis to other assets; (4) recognizing that other provisions in subchapter K (for example, section 743(b)) already apply to prevent many of the potential abuses; and (5) providing administrable rules for partners, partnerships, and the IRS. The Treasury Department and the IRS concluded that these considerations and the policy rationale underlying the successor rule for section 381 transactions in the legislative history weigh in favor of applying similar successor rules to other nonrecognition transactions, including section 721 transactions, section 351 transactions, and distributions governed by section 731. Thus, when the partnership interest is transferred in one of these nonrecognition transactions, the transferee generally succeeds to the transferor's section 704(c)(1)(C) basis adjustments attributable to the interest transferred and is treated as the section 704(c)(1)(C) partner with respect to such interest. If the nonrecognition transaction is described in section 168(i)(7)(B), then the rules in section 168(i)(7)(A) apply with respect to the transferor's cost recovery deductions under section 168 with respect to the section 704(c)(1)(C) basis adjustment. The proposed regulations further provide that if gain or loss is recognized in the transaction, appropriate adjustments must be made to the section 704(c)(1)(C) basis adjustment.

The Treasury Department and the IRS believe that a section 743(b) adjustment generally will prevent inappropriate duplication of loss when a partnership has a section 754 election in effect or a substantial built-in loss with respect to the transfer. (*See* Part 2.a.i. of the Explanation of Provisions section of this preamble for rules regarding substantial built-in loss transactions). To the extent that the transferee partner's basis in the transferred partnership interest does not reflect a built-in loss, a section 743(b) adjustment should require the partnership to reduce the basis of its properties to reflect the elimination of the built-in loss. The Treasury Department and the IRS believe that the amount of the section 704(c)(1)(C) adjustment and any negative 743(b) adjustment should be netted for this purpose. The Treasury Department and the IRS believe that similar treatment is appropriate when a partnership does not have a section 754 election in effect at the time of transfer to prevent duplication of the built-in loss. Therefore, regardless of whether a section 754 election is in effect or a substantial built-in loss exists with respect to a transfer, the proposed regulations provide that the transferee partner succeeds to the transferor's section 704(c)(1)(C) basis adjustment, as reduced by the amount of any negative section 743(b) adjustment that would be allocated to the section 704(c)(1)(C) property if the partnership had a section 754 election in effect at the time of the transfer.

The proposed regulations also provide that the general rule regarding nonrecognition transactions does not apply to the transfer of all or a portion of a section 704(c)(1)(C) partner's partnership interest by gift because the gift recipient does not fit within Congress's notion of a successor as described in the legislative history. *See* Conference Report, at 623 n. 546. Thus, the general transfer rule applies instead, and the section 704(c)(1)(C) basis adjustment is eliminated.

f. *Transfers of section 704(c)(1)(C) property*

The proposed regulations also provide guidance on the treatment of the section 704(c)(1)(C) partner and the section 704(c)(1)(C) basis adjustment when the partnership transfers section 704(c)(1)(C) property. Consistent with the rules under section 743, a section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment is generally taken into account in determining the section 704(c)(1)(C) partner's income, gain, loss, or deduction from the sale or exchange of section 704(c)(1)(C) property.

With certain exceptions, if section 704(c)(1)(C) property is transferred in a nonrecognition transaction, the proposed regulations provide that the section 704(c)(1)(C) partner retains the section 704(c)(1)(C) basis adjustment in the replacement property (in the case of a section 1031 transaction), in stock (in the case of a section 351 transaction), in a lower-tier partnership interest (in the case of a section 721 transaction), or in the same property held by a new partnership (in the case of a section 708(b)(1)(B) technical termination). The proposed regulations also provide additional rules for section 721 and section 351 transactions, which are described in the following sections.

i. *Contribution of section 704(c)(1)(C) property under section 721*

The proposed regulations provide rules for when, after a section 704(c)(1)(C) partner contributes section 704(c)(1)(C) property to an upper-tier partnership, the upper-tier partnership contributes the property to a lower-tier partnership in a transaction described in section 721(a). The proposed regulations ensure that the section 704(c)(1)(C) adjustment amount is ultimately tracked back to the initial contributing partner, similar to the rules for section 721 contributions of property in which a partner has a section 743(b) adjustment.

In particular, the proposed regulations provide that the interest in the lower-tier partnership received by the upper-tier partnership is treated as the section 704(c)(1)(C) property with the same section 704(c)(1)(C) basis adjustment as the contributed property. The lower-tier partnership determines its basis in the contributed property by excluding the existing section 704(c)(1)(C) basis adjustment. However, the lower-tier partnership also succeeds to the upper-tier partnership's section 704(c)(1)(C) basis adjustment. The portion of the upper-tier partnership's basis in its interest in the lower-tier partnership attributable to the section 704(c)(1)(C) basis adjustment must be segregated and allocated solely to the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made. Similarly, the section 704(c)(1)(C) basis adjustment to which the lower-tier partnership succeeds must be segregated and allocated solely to the upper-tier partnership, and the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made. If gain or loss is recognized on the transaction, appropriate adjustments must be made to the section 704(c)(1)(C) basis adjustment.

The proposed regulations provide that to the extent that any section 704(c)(1)(C) basis adjustment in a tiered partnership is recovered (for example, by sale or depreciation of the property), or is otherwise reduced, upper or lower partnerships in the tiered structure must make conforming reductions to related section 704(c)(1)(C) basis adjustments to prevent duplication of loss.

The proposed regulations recognize that the contribution from the upper-tier partnership to the lower-tier partnership will give rise to an additional section 704(c)(1)(C) basis adjustment if the value of the property has fallen below its common basis to the upper-tier partnership; this additional section 704(c)(1)(C) adjustment will be allocated among the partners of the upper-tier partnership in a manner that reflects their relative shares of that loss.

ii. *Transfer of section 704(c)(1)(C) property in a section 351 transaction*

The transfer of the section 704(c)(1)(C) property by a partnership to a corporation in a section 351 transaction severs the contributing partner's connection with the section 704(c)(1)(C) property at the partnership level. The section 704(c)(1)(C) partner, now an indirect shareholder of the corporation, no longer has a section 704(c)(1)(C) basis adjustment with respect to the property. The proposed regulations provide that if, in an exchange described in section 351, a partnership transfers section 704(c)(1)(C) property to a corporation, the stock the partnership receives in the exchange is treated, solely with respect to the section 704(c)(1)(C) partner, as section 704(c)(1)(C) property that generally has the same section 704(c)(1)(C) basis adjustment as the section 704(c)(1)(C) property transferred to the corporation (reduced by any portion of the section 704(c)(1)(C) basis adjustment that reduced the partner's share of any gain on the transaction). The transferee corporation's adjusted basis in the transferred property is determined under section 362 (including by applying section 362(e)), taking into account any section 704(c)(1)(C) basis adjustments in the transferred property. However, the proposed regulations provide that, if a partnership recognizes gain on the transfer, the partnership's gain is determined without regard to any section 704(c)(1)(C) basis adjustment, but the section 704(c)(1)(C) partner's gain does take into account the section 704(c)(1)(C) basis adjustment. *See* § 1.362–4(e)(1) for additional rules regarding the application of section 362(e) to transfers by partnerships.

iii. *Partnership technical terminations*

The proposed regulations provide that a partner with a section 704(c)(1)(C) basis adjustment in section 704(c)(1)(C) property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same section 704(c)(1)(C) basis adjustment with respect to section 704(c)(1)(C) property deemed contributed by the terminated partnership to the new partnership under § 1.708–1(b)(4). In addition, the deemed contribution of property by a terminated partnership to a new partnership is not subject to the proposed regulations and does not create a section 704(c)(1)(C) basis adjustment.

iv. *Miscellaneous provisions*

The proposed regulations also provide additional rules for like-kind exchanges of section 704(c)(1)(C) property, dispositions of section 704(c)(1)(C) property in installment sales, and contributed contracts.

g. *Reporting requirements under section 704(c)(1)(C)*

The proposed regulations prescribe certain reporting requirements for section 704(c)(1)(C) basis adjustments that are similar to the requirements for section 743(b) adjustments. Specifically, the proposed regulations provide that a partnership that owns property for which there is a section 704(c)(1)(C) basis adjustment must attach a statement to the partnership return for the year of the contribution of the section 704(c)(1)(C) property setting forth the name and taxpayer identification number of the section 704(c)(1)(C) partner as well as the section 704(c)(1)(C) basis adjustment and the section 704(c)(1)(C) property to which the adjustment relates.

2. *Mandatory Basis Adjustment Provisions*

a. *Section 743 substantial built-in loss provisions*

i. *General provisions*

The proposed regulations generally restate the statutory language in section 743(a) and (b) regarding substantial built-in losses, but provide additional guidance in several areas. The proposed regulations clarify that, if a partnership has a substantial built-in loss immediately after the transfer of a partnership interest, the partnership is treated as having a section 754 election in effect for the taxable year in which the transfer occurs, but only with respect to that transfer (unless another transaction is also subject to the mandatory basis adjustment provisions of sections 734 or 743).

The proposed regulations also provide that in determining whether there is a substantial built-in loss, section 743(b) adjustments and section 704(c)(1)(C) basis adjustments (except the transferee's section 743(b) adjustments and section 704(c)(1)(C) basis adjustments, if any) are disregarded.

The proposed regulations also provide special rules for determining fair market value in the case of a tiered partnership. The Treasury Department and the IRS are aware that there is some uncertainty as to how to determine the fair market value of a lower-tier partnership interest for purposes of determining whether the partnership has a substantial built-in loss in its assets when the upper-tier partnership is allocated a share of the lower-tier partnership's liabilities under section 752. The Treasury Department and the IRS believe it is appropriate for this purpose to gross up the fair market value of the lower-tier partnership interest by the upper-tier partnership's allocated share of liabilities; otherwise, the regulations could inappropriately treat a lower-tier partnership interest as a loss asset. Thus, under the proposed regulations, the fair market value of a lower-tier partnership interest (solely for purposes of computing the upper-tier partnership's basis adjustment under section 743(b)) is equal to the sum of: (i) the amount of cash that the upper-tier partnership would receive if the lower-tier partnership sold all of its property for cash to an unrelated person for an amount equal to the fair market value of such property, satisfied all of its liabilities, and liquidated; and (ii) the upper-tier partnership's share of the lower-tier partnership's liabilities (as determined under section 752 and the regulations).

In addition, the proposed regulations provide special rules for basis adjustments with respect to tiered partnerships. Under the authority granted by section 743(d)(2), the proposed regulations provide that if a partner transfers an interest in an upper-tier partnership that holds a direct or indirect interest in a lower-tier partnership, and the upper-tier partnership has a substantial built-in loss with respect to the transfer, each lower-tier partnership is treated, solely with respect to the transfer, as if it had made a section 754 election for the taxable year of the transfer. The Treasury Department and the IRS are aware of the practical and administrative difficulties associated with requiring a lower-tier partnership that has not elected under section 754 to adjust the basis of its assets in connection with the transfer of an interest in an upper-tier partnership. Comments are requested on the scope of this rule and on measures to ease administrative burdens while still accomplishing the objective of the statute.

These proposed regulations also provide guidance on the application of section 743(b) adjustments in tiered partnership situations generally. Consistent with Rev. Rul. 87–115, 1987–2 CB 163, the proposed regulations provide that if an interest in an upper-tier partnership that holds an interest in a lower-tier partnership is transferred by sale or exchange or upon the death of a partner, and the upper-tier partnership and the lower-tier partnership both have elections in effect under section 754, then an interest in the lower-tier partnership will be deemed to have been transferred by sale or exchange or upon the death of a partner, as the case may be. The amount of the interest in the lower-tier partnership deemed to have been transferred is the portion of the upper-tier partnership's interest in the lower-tier partnership that is attributable to the interest in the upper-tier partnership being transferred. Accordingly, to the extent the adjusted basis of the upper-tier partnership's interest in a lower-tier partnership is adjusted, the lower-tier partnership must adjust the basis of its properties.

Section 743(e)(7) provides that the Secretary may prescribe regulations for applying the EIP rules to tiered partnerships, and the legislative history makes clear that Congress did not intend for EIPs to avoid the mandatory basis adjustment provisions through the use of tiered partnerships. *See* Conference Report, at 627. The Treasury Department and the IRS believe that the same concerns exist for tiered EIPs as exist for all other partnerships subject to the mandatory basis adjustment provisions. Accordingly, the proposed regulations do not include specific rules for tiered EIPs beyond the rules governing all tiered partnerships.

The proposed regulations provide anti-abuse rules. The purpose of the amendments to section 743 is to prevent a partner that purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect from being allocated a share of the loss when the partnership disposes of the property or takes cost recovery deductions with respect to the property. Accordingly, consistent with the purpose of the amendments and the specific grant of regulatory authority in section 743(d)(2), the proposed regulations provide that the provisions of section 743 and the regulations thereunder regarding substantial built-in loss transactions must be applied in a manner consistent with the purpose of such provisions and the substance of the transaction. Thus, if a principal purpose of a transaction is to avoid the application of the substantial built-in loss rules with respect to a transfer, the Commissioner can recast the transaction for Federal income tax purposes as appropriate to achieve tax results that are consistent with the purpose of the provisions. Whether a tax result is inconsistent with the purpose of the substantial built-in loss provisions is determined based on all the facts and circumstances. For example, under the proposed regulations, property held by related partnerships may be aggregated and a contribution of property to a partnership may be disregarded in applying the substantial built-in loss provisions in section 743 and the regulations thereunder if the property was transferred with a principal purpose of avoiding the application of such provisions.

Finally, the proposed regulations clarify that a partnership that has a substantial built-in loss immediately following the transfer of a partnership interest must comply with certain provisions of § 1.743–1(k). In this case, the partnership must attach a statement of adjustments to its partnership return as if an election under section 754 were in effect at the time of the transfer solely with respect to the transfer for which there is a substantial built-in loss.

One commenter on the Notice requested that the Treasury Department and the IRS provide a de minimis exception for the substantial built-in loss provisions for transfers of small interests (subject to an annual limit on aggregate transfers during a taxable year). The substantial built-in loss provisions are intended to prevent the inappropriate shifting of losses among partners, and neither the legislative history nor the statute suggests that Congress intended to limit the scope of the rule to the transfer of large interests. Accordingly, the Treasury Department and the IRS decline to provide an exception to the substantial built-in loss rules based on the size of the interest transferred. The Treasury Department and the IRS will continue to study, and request comments on, whether a rule is warranted that excludes de minimis basis adjustments from the mandatory adjustment provisions.

ii. *EIPs*

The proposed regulations generally adopt the statutory language in section 743(e) and the provisions in the Notice. The Notice requested comments on certain aspects of the interim procedures for EIPs, and the Treasury Department and the IRS received comments in response to that request, which are described in this section.

The Notice detailed reporting requirements for transferors of EIP interests so that transferees could comply with the loss limitation rule in section 743(e)(2). The proposed regulations clarify that the reporting requirements with respect to transferors of an interest in an EIP described in the Notice do not apply if the transferor recognizes gain on the transfer and no prior transferor recognized a loss on any transfer. The Treasury Department and the IRS do not believe reporting is necessary in this limited circumstance because the transferee should not be subject to the loss limitation rule of section 743(e)(2).

In regard to the requirement in section 743(e)(6)(I) that the partnership agreement provide for a term that is not in excess of 15 years, one commenter requested that regulations provide that a partnership may still qualify as an EIP even if the partnership's initial term is greater than 15 years, particularly in cases in which the amount of the partnership's equity investment in the remaining assets is small (for example, 25 percent of the total committed capital). However, Congress considered the circumstances in which it would be appropriate to provide an extension of the term and specifically provided an exception to the 15-year requirement for EIPs in existence on June 4, 2004. Accordingly, the Treasury Department and the IRS decline to adopt this comment in the proposed regulations.

The Notice also provides guidance on whether a partnership has ever been engaged in a trade or business for purposes of section 743(e)(6)(C). The Notice provides that until further guidance is issued, an upper-tier partnership will not be treated as engaged in the trade or business of a lower-tier partnership if, at all times during the period in which the upper-tier partnership owns an interest in the lower-tier partnership, the adjusted basis of its interest in the lower-tier partnership is less than 25 percent of the total capital that is required to be contributed to the upper-tier partnership by its partners during the entire term of the upper-tier partnership (the "25% Rule"). The Notice specifically requests comments on rules that would be appropriate for future guidance in determining whether an upper-tier partnership is treated as engaged in a trade or business that is conducted by a lower-tier partnership. One commenter requested that the Treasury Department and the IRS confirm whether the 25% Rule is a safe harbor or whether a violation of the 25% Rule disqualifies a partnership from being an EIP. This commenter also requested that the Treasury Department and the IRS clarify the 25% Rule in the case of borrowing. The commenter noted that lower-tier partnership interests are often acquired with capital contributions and the proceeds of borrowing. Therefore, the commenter requested that any safe harbor take into account leverage. This commenter further suggested that rules similar to the rules in § 1.731–2(e)(3) (providing circumstances in which a partnership would not be treated as engaged in a trade or business for purposes of section 731(c)(3)(C)) should apply for purposes of section 743(e)(6)(C). Finally, the commenter requested that the Treasury Department and the IRS provide additional safe harbors (for example, where the upper-tier partnership is organized for investment services and the partners and managers of the upper-tier partnership do not engage in the day-to-day operations of the lower-tier partnership's trade or business activity, but partners and/or managers are on the board of directors of the lower-tier partnership).

The Treasury Department and the IRS view the 25% Rule as a bright-line rule. Therefore, a failure to meet the 25% Rule will mean that the partnership fails to qualify as an EIP. The Treasury Department and the IRS agree that the rules in § 1.731–2(e)(3) should apply for purposes of section 743(e)(6)(C). Therefore, the proposed regulations provide a safe harbor by cross-referencing those rules. Under the proposed regulations, if a partnership would not be treated as engaged in a trade or business under § 1.731–2(e)(3) for purposes of section 731(c)(3)(C), the partnership also will not be treated as engaged in a trade or business for purposes of section 743(e)(6)(C). The Treasury Department and the IRS believe the 25% Rule and the cross-reference to § 1.731–2(e)(3) provide appropriate guidance under section 743(e)(6)(C) and therefore the proposed regulations do not provide any additional safe harbors. The Treasury Department and the IRS are continuing to study the extent to which borrowing should be taken into account in applying the 25% Rule and therefore request comments on appropriate rules.

A commenter also requested additional guidance regarding section 743(e)(6)(H), which provides that one of the eligibility requirements for an EIP is that the partnership agreement have substantive restrictions on each partner's ability to cause a redemption of the partner's interest. The proposed regulations follow the examples in the legislative history and provide that substantive restrictions for purposes of section 743(e)(7)(H) include cases in which a redemption is permitted under a partnership agreement only if the redemption is necessary to avoid a violation of state, federal, or local laws (such as ERISA or the Bank Holding Company Act) or the imposition of a federal excise tax on, or a change in the federal tax-exempt status of, a tax-exempt partner.

See Conference Report at 626. The Treasury Department and the IRS request comments on other restrictions that could be considered substantive restrictions on a partner's ability to cause a redemption of the partner's interest for purposes of section 743(e)(6)(H).

The proposed regulations provide that the EIP election must be made on a timely filed original return, including extensions. One commenter requested relief for certain instances in which the partnership fails to make a valid EIP election. The commenter requested relief when: (1) a partnership makes an EIP election, but did not qualify to make the election; (2) the partnership attempts to make an EIP election, but it is defective; or (3) the partnership makes an EIP election, but fails to continue to qualify. In each case, the commenter believes that the Treasury Department and the IRS should treat the partnership as an EIP if: (a) its failure to qualify or the defect was inadvertent; (b) the partners and the partnership consistently treated the partnership as an EIP; (c) steps were taken to cure the defect in a reasonable period of time; and (d) the partners and the EIP agree to make any necessary adjustments. The Treasury Department and the IRS do not adopt this comment in the proposed regulations because there are existing procedures for situations in which a regulatory election is defective.

The Treasury Department and the IRS request comments on appropriate rules for situations in which a partnership that has elected to be an EIP fails to qualify in a particular year, but then qualifies again in a future year. The Treasury Department and the IRS also request comments on the circumstances in which a qualifying partnership that has revoked an EIP election should be permitted to reelect and the rules and procedures that should apply to the reelection.

iii. *Securitization partnerships*

The proposed regulations generally restate the statutory provisions relating to the exception from the substantial built-in loss provisions for securitization partnerships.

b. *Section 734 substantial basis reduction provisions*

i. *General provisions*

The proposed regulations generally follow the statutory provisions regarding substantial basis reductions. Questions have been raised regarding whether the $250,000 threshold in section 734(d)(1) applies to a partnership's aggregate distributions for a taxable year. The Treasury Department and the IRS believe that the better interpretation of section 734(a), (b), and (d) is that the threshold applies separately with respect to each distributee because: (1) both section 734(a) and (b) refer to a distribution of property to "a partner;" and (2) section 734(b)(2)(A) and (B), referenced in section 734(d), refer to the "distributee partner" or the "distributee." These references indicate that the substantial built-in loss provisions apply to each partner-distributee separately, but with respect to the entire distribution made to the distributee. That is, where multiple properties are distributed to a partner-distributee, the $250,000 threshold is determined by reference to all properties distributed to the partner-distributee as part of the same distribution.

The proposed regulations also provide additional guidance in several areas. The proposed regulations provide that if there is a substantial basis reduction, the partnership is treated as having an election under section 754 in effect for the taxable year in which the distribution occurs, but solely for the distribution to which the substantial basis reduction relates (unless another transaction is subject to the mandatory basis adjustment provisions of sections 734 or 743). For example, if a partnership without a section 754 election in effect has a substantial basis reduction with respect to a distribution, and a partner in the partnership in that same year transfers a partnership interest (and the partnership does not have a substantial built-in loss immediately after the transfer), the partnership will be treated as having a section 754 election in effect for the distribution but not the transfer.

The same issues exist in the context of section 734(b) adjustments and tiered partnerships as exist with respect to section 743(b) adjustments and tiered partnerships. Thus, the proposed regulations also provide guidance for substantial basis reductions in tiered partnership arrangements. Under the proposed regulations, if there is a substantial basis reduction with respect to a distribution by an upper-tier partnership that (either directly or indirectly through one or more partnerships) holds an interest in a lower-tier partnership, each lower-tier partnership is treated, solely with respect to the distribution, as if it had made an election under section 754 for the taxable year in which the distribution occurs.

These proposed regulations also provide guidance on the application of section 734(b) adjustments in tiered partnership situations generally. Consistent with Rev. Rul. 92–15, 1992–1 CB 215, if an upper-tier partnership makes an adjustment under section 734(b) to the basis of an interest it holds in a lower-tier partnership that has an election under section 754 in effect, the lower-tier partnership must make adjustments to the upper-tier partnership's share of the lower-tier partnership's assets. The amount of the lower-tier partnership's adjustment is equal to the adjustment made by the upper-tier partnership to the basis of its interest in the lower-tier partnership. The lower-tier partnership's adjustment to the upper-tier partnership's share of its assets is for the upper-tier partnership only and does not affect the basis in the lower-tier partnership's property for the other partners of the lower-tier partnership.

The Treasury Department and the IRS are aware of the practical and administrative difficulties associated with the requirement that a lower-tier partnership adjust the basis of its assets with respect to adjustments under both section 734 and section 743 and request comments on the scope of this rule and measures to ease the administrative burden while still accomplishing the objective of the statute.

The proposed regulations also update § 1.734–1(d) to clarify that its reporting requirements apply if there is a substantial basis reduction with respect to a distribution. In this case, the provisions of § 1.734–1(d) apply solely with respect to the distribution to which the substantial basis reduction relates as if an election under section 754 were in effect at the time of the transfer.

ii. *Securitization partnerships*

The proposed regulations generally restate the statutory provisions relating to the exception from the substantial basis reduction provisions for securitization partnerships.

3. *Section 755 Basis Allocation Rules*

a. *Section 755(c)*

The proposed regulations generally restate the statutory provisions of section 755(c) and provide rules applicable to an allocation of a downward adjustment in the basis of partnership property under sections 734(b) and 755(a). As discussed in Part 3 of the Background section of this preamble, Congress enacted section 755(c) in response to the JCT's investigation of Enron Corporation. In addressing transactions among related parties, the JCT Enron Report specifically provides that:

> Partnership allocations between members of the same affiliated group (and, in general, related parties) may not have the same economic consequences as allocations between unrelated partners. As a result, related partners can use the partnership allocation rules inappropriately to shift basis among assets . . . The Joint Committee staff recommends that . . . the partnership basis rules should be altered to preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner (or related party).

JCT Enron Report, at 29–30. The proposed regulations provide that in making an allocation under section 755(a) of any decrease in the adjusted basis of partnership property under section 734(b), no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) or 707(b)(1)) to such corporation) that is a partner in the partnership. Given Congress's intent to prevent taxpayers from shifting tax gain to stock of a corporate partner or corporation related to a corporate partner, the Treasury Department and the IRS believe it is appropriate to interpret section 755(c) to apply broadly to related persons under either section 267(b) or section 707(b)(1). *See* Grassley Report, at 127 and House Committee Report, at 287. If section 755(c) only applied to persons treated as related within the meaning of both section 267(b) and section 707(b)(1), then the provision would apply in very limited circumstances, significantly restricting the scope of section 755(c).

b. *Modification of basis allocation rules for substituted basis transactions*

The Treasury Department and the IRS are aware that the current basis allocation rules for substituted basis transactions can result in unintended consequences, particularly with regard to the "net gain" and "net loss" requirement in § 1.755–1(b)(5)(ii). The net gain or net loss requirement in § 1.755–1(b)(5)(ii) may, in certain situations, cause a partnership to be unable to properly adjust the basis of partnership property with respect to a transferee partner. For example, when there is an increase in basis to be allocated to partnership assets and the property of the partnership does not have overall unrealized net gain or net income, the basis increase cannot be allocated under § 1.755–1(b)(5). Conversely, if there is a decrease in basis to be allocated to partnership assets and the property of the partnership does not have overall unrealized net loss, the basis decrease cannot be allocated under § 1.755–1(b)(5). The Treasury Department and the IRS believe this result is inappropriate. Accordingly, the Treasury Department and the IRS propose to amend the current regulations as described in this preamble.

i. *Allocations between classes of property*

The proposed regulations provide that if there is an increase in basis to be allocated to partnership assets under § 1.755–1(b)(5), the increase must be allocated between capital gain property and ordinary income property in proportion to, and to the extent of, gross gain or gross income (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. The proposed regulations further provide that any remaining increase must be allocated between the classes in proportion to the fair market value of all property in each class.

If there is a decrease in basis to be allocated to partnership assets under § 1.755–1(b)(5), the proposed regulations provide that the decrease must be allocated between capital gain property and ordinary income property in proportion to, and to the extent of, the gross loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining decrease must be allocated between the classes in proportion to the transferee's shares of the adjusted bases of all property in each class (as adjusted under the preceding sentence). Thus, the proposed regulations remove the requirements that (1) there be an overall net gain or net income in partnership property for an increase in basis to be allocated to a particular class of property; and (2) there be an overall net loss in partnership property for a decrease in basis to be allocated to a particular class of property.

ii. *Allocations within classes of property*

The Treasury Department and the IRS are aware that there is uncertainty regarding whether the transferee's shares of unrealized appreciation and depreciation described in § 1.755–1(b)(5)(iii)(A) and (B) include only amounts attributable to the acquired partnership interest. The proposed regulations clarify that the transferee's shares of the items are limited to the amounts attributable to the acquired partnership interest.

In addition, § 1.755–1(b)(5)(iii)(C) has a limitation that provides that a transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class. By focusing on the transferee's share of adjusted basis with respect to only depreciated assets in the class, as opposed to all assets in the class, this rule subjects more of the negative basis adjustment to the carryover rules in § 1.755–1(b)(5)(iii)(D). The Treasury Department and the IRS believe this result is inappropriate. Accordingly, the proposed regulations provide that if a decrease in basis must be allocated to partnership property and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all assets in that class, the basis of the property is reduced to zero (but not below zero). Therefore, under the proposed regulations, the negative basis adjustment is no longer limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in a class.

c. *Succeeding to transferor's basis adjustment*

The proposed regulations amend the regulations under section 743 to provide an exception to the rule that a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. The Treasury Department and the IRS believe that this rule can lead to inappropriate results when the transferor transfers its partnership interest in a substituted basis transaction (within the meaning of § 1.755–1(b)(5)) and the transferor had a basis adjustment under section 743(b) attributable to the transferred interest that was allocated pursuant to § 1.755–1(b)(2) through (b)(4). Under the current regulations, the transferee does not succeed to the transferor's section 743(b) adjustment but, rather, is entitled to a new section 743(b) adjustment that is allocated under a different set of rules, which may result in the inappropriate shifting of basis among the partnership's assets. The proposed regulations provide that the transferee in a substituted basis transaction succeeds to that portion of the transferor's basis adjustment attributable to the transferred partnership interest and that the adjustment is taken into account in determining the transferee's share of the adjusted basis to the partnership for purposes of §§ 1.743–1(b) and 1.755–1(b)(5).

4. *Miscellaneous Provisions*

a. *Special rules for forward and reverse section 704(c) allocations*

One commenter on Notice 2009–70 noted that the definitions of the terms "built-in gain" and "built-in loss" in § 1.704–3(a)(3)(ii) imply that section 704(c) layers with "different signs" should be netted against each other because the regulations provide that built-in gain or built-in loss is reduced by decreases in the difference between the property's adjusted tax basis and book value.

In response to this comment, the proposed regulations provide that built-in gain and built-in loss do not take into account any decreases or increases, as the case may be, to the property's book value pursuant to a revaluation of partnership property under § 1.704–1(b)(2)(iv)(*f*) or § 1.704–1(b)(2)(iv)(*s*). Thus, for example, under the proposed regulations, reverse section 704(c) allocations do not reduce forward section 704(c) gain or loss.

The Treasury Department and the IRS also received several comments regarding the proper treatment of section 704(c) layers, suggesting one of two approaches. Under the layering approach, a partnership would create and maintain multiple section 704(c) layers for the property. Under the netting approach, a partnership would net multiple section 704(c) layers for the property and therefore each section 704(c) property would have one section 704(c) layer. One commenter recommended that the layering approach be the default rule, but that certain partnerships should be permitted to adopt a netting approach depending on the value of the partnership's assets. This commenter believed that the layering approach is more appropriate because the netting approach can result in distortions when partnerships use the traditional method of allocating section 704(c) amounts and the ceiling rule is implicated. The commenter also argued that the layering approach better maintains the economic expectations of the partners and is generally more consistent with the policy underlying section 704(c). However, this commenter also acknowledged that the netting approach is simpler to apply, and that in many cases both approaches will reach the same result. Another commenter suggested that partnerships be given the option of using either the layering approach or the netting approach. According to the commenter, this would allow partnerships to avoid the burden and expense of maintaining section 704(c) layers, particularly when maintaining section 704(c) layers is unnecessary.

The proposed regulations do not permit taxpayers to use a netting approach because a netting approach could lead to distortions. The Treasury Department and the IRS understand, however, that maintaining section 704(c) layers may result in additional administrative burdens and, therefore, request comments on when it is appropriate for partnerships to use a netting approach (for example, small partnerships).

One commenter noted that guidance was necessary with respect to how to allocate tax items among multiple section 704(c) layers. This commenter suggested three methods for allocating tax items: (1) allocate tax items to the oldest layer first; (2) allocate tax items to the newest section 704(c) layers first; and (3) allocate tax items among the section 704(c) layers pro rata based on the amount of each layer. The commenter suggested that the Treasury Department and the IRS provide a default rule that would allocate to the oldest section 704(c) layers first, but permit partnerships to elect any reasonable method (such as the three methods described).

The Treasury Department and the IRS agree that partnerships should be permitted to use any reasonable method in allocating tax items. The Treasury Department and the IRS decline to adopt a default rule for allocating tax items because no single method is more appropriate than other methods. Therefore, the proposed regulations provide that a partnership may use any reasonable method to allocate items of income, gain, loss, and deduction associated with an item of property among the property's forward and reverse section 704(c) layers subject to the anti-abuse rule in § 1.704–3(a)(10). The partnership's choice of method is also subject to § 1.704–3(a)(2), which provides that a partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods is reasonable based on the facts and circumstances and consistent with the purpose of section 704(c). The Treasury Department and the IRS are considering providing examples of reasonable methods in future guidance and therefore request comments on these and other methods for allocating tax items.

b. *Extension of time period for taxing precontribution gain*

The proposed regulations amend various provisions in §§ 1.704–4, 1.737–1, and 1.1502–13 to reflect the amendments to sections 704(c)(1)(B) and 737(b)(1) that lengthen the period of time for taxing precontribution gain from five years to seven years. The proposed regulations also clarify how partners determine the seven-year period. Specifically, the proposed regulations provide that the seven-year period begins on, and includes, the date of contribution, and ends on, and includes, the last date that is within seven years of the contribution.

Proposed Effective Date

These regulations are generally proposed to apply to partnership contributions and transactions occurring on or after the date final regulations are published in the **Federal Register**. The proposed regulations under § 1.755–1(b)(5) will apply to transfers of partnership interests occurring on or after January 16, 2014**.** No inference is intended as to the tax consequences of transactions occurring before the effective date of these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in this notice of proposed rulemaking will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). The Treasury Department and the IRS believe that the economic impact on small entities as a result of the collection of information in this notice of proposed rulemaking will not be significant. The small entities subject to the collection are business entities formed as partnerships that: (1) receive a contribution of built-in loss property; (2) are required to make a mandatory basis adjustment under section 734 or section 743; and/or (3) are eligible for, and elect to apply, the electing investment partnership provisions in section 743(e). In the case of the contribution of built-in loss property, the partnership is required to provide a statement in the year of contribution setting forth basic information that the partnership will need in order to properly apply the rules. Similarly, in the case of the mandatory basis adjustment provisions, the partnership will already have the information subject to the collection in order to comply with the rules. In the case of EIPs, the collections are either one-time (election) or annual (annual statement). The collection only applies if the partnership elects to be an EIP. Furthermore, the proposed regulations provide the specific language for the annual statement. Finally, the collection regarding the mandatory basis adjustment provisions and the EIP rules have been in effect since 2005, as required by Notice 2005–32, and the Treasury Department and the IRS have not received comments that the collections have a significant economic impact. For these reasons, the Treasury Department and the IRS do not believe that the collection of information in this notice of proposed rulemaking has a significant economic impact. Pursuant to section 7805(f) of the 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 the proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 30, 2014, beginning at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by April 16, 2014, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 16, 2014. 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 authors of these regulations are Wendy L. Kribell and Benjamin H. Weaver, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

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 1.704–3 is amended by:

1. Revising paragraph (a)(3)(ii).
2. Adding paragraph (a)(3)(iii).
3. Revising paragraph (a)(6)(i).
4. Adding paragraph (a)(6)(iii).
5. Adding paragraph (a)(6)(iv).
6. Revising paragraph (a)(7).
7. Revising the first sentence in paragraph (a)(10) by removing

the word "allocation" before the word "method".

8. Redesignating paragraph (f) as paragraph (g).
9. Adding a new paragraph (f).
10. Adding a sentence at the end of newly redesignated paragraph (g).

The revisions and additions read as follows.

§ 1.704–3 Contributed property.

(a) * * *

(3) * * *

(ii) *Built-in gain and built-in loss*. The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis (other than decreases to the property's book value pursuant to § 1.704–1(b)(2)(iv)(*f*) or § 1.704–1(b)(2)(iv)(*s*)). The built-in loss on section 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted tax basis and book value (other than increases to the property's book value pursuant to § 1.704–1(b)(2)(iv)(*f*) or § 1.704–1(b)(2)(iv)(*s*)). For purposes of paragraph (a)(6)(iii) and (iv) of this section, a built-in gain or built-in loss referred to in this paragraph shall be referred to as a forward section 704(c) allocation. *See* § 1.460–4(k)(3)(v)(A) for a rule relating to the amount of built-in income or built-in loss attributable to a contract accounted for under a long-term contract method of accounting.

(iii) *Effective/applicability date*. The provisions of paragraph (a)(3)(ii) of this section apply to partnership contributions and transactions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. * * *

* * * * *

(6) (i) *Revaluations under section 704(b)*. The principles of this section apply with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to section 1.704–1(b)(2)(iv)(*f*) or section 1.704–1(b)(2)(iv)(*s*) (reverse section 704(c) allocations). Each such revaluation creates a separate amount of built-in gain or built-in loss, as the case may be (a section 704(c) layer), that must be tracked separately from built-in gain or built-in loss arising from contribution (a forward section 704(c) layer) and any other revaluation (a reverse section 704(c) layer). For instance, one section 704(c) layer with respect to a particular property may be of built-in gain, and another section 704(c) layer with respect to the same property may be of built-in loss.

* * * * *

(iii) *Allocation method*. A partnership may use any reasonable method to allocate the items of income, gain, loss, and deduction associated with an item of property among the property's forward and reverse section 704(c) layers.

(iv) *Effective/applicability date*. The provisions of paragraph (a)(6)(iii) of this section apply to partnership contributions and transactions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register.**

* * * * *

(7) *Transfers of a partnership interest*. If a contributing partner transfers a partnership interest, built-in gain must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain proportionate to the interest transferred must be allocated to the transferee partner. Rules for the allocation of built-in loss are provided in paragraph (f) of this section.

* * * * *

(f) *Special rules for built-in loss property*—(1) *General principles*—(i) *Contributing partner*. If a partner contributes section 704(c)(1)(C) property (as defined in paragraph (f)(2)(i) of this section) to a partnership, the excess of the adjusted basis of the section 704(c)(1)(C) property (determined without regard to paragraph (f)(1)(ii) of this section) over its fair market value immediately before the contribution will be taken into account only in determining the amount of items allocated to the section 704(c)(1)(C) partner (as defined in paragraph (f)(2)(ii) of this section) that contributed such section 704(c)(1)(C) property.

(ii) *Non-contributing partners*. In determining the amount of items allocated to partners other than the section 704(c)(1)(C) partner, the initial basis of section 704(c)(1)(C) property in the hands of the partnership is equal to the property's fair market value at the time of contribution.

(2) *Definitions*. For purposes of this section—

(i) *Section 704(c)(1)(C) property*. The term *section 704(c)(1)(C) property* means section 704(c) property (as defined in paragraph (a)(3)(i) of this section) with a built-in loss at the time of contribution. Section 704(c)(1)(C) property does not include a § 1.752–7 liability (within the meaning of § 1.752–7(b)(3)) or property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to § 1.704–1(b)(2)(iv)(*f*) or § 1.704–1(b)(2)(iv)(*s*).

(ii) *Section 704(c)(1)(C) partner*. The term *section 704(c)(1)(C) partner* means a partner that contributes section 704(c)(1)(C) property to a partnership.

(iii) *Section 704(c)(1)(C) basis adjustment*. A property's section 704(c)(1)(C) basis adjustment is initially equal to the excess of the adjusted basis of section 704(c)(1)(C) property (determined without regard to paragraph (f)(1)(ii) of this section) over its fair market value immediately before the contribution, and is subsequently adjusted for the recovery of the section 704(c)(1)(C) basis adjustment under paragraph (f)(3)(ii)(D) of this section.

(3) *Operational rules*—(i) *In general*. Except as provided in this section, section 704(c)(1)(C) property is subject to the rules and regulations applicable to section 704(c) property. *See*, for example, § 1.704–3(a)(9).

(ii) *Effect of section 704(c)(1)(C) basis adjustment*—(A) *In general*. The section 704(c)(1)(C) basis adjustment is an adjustment to the basis of partnership property with respect to the section 704(c)(1)(C) partner only. A section 704(c)(1)(C) basis adjustment amount is excluded from the partnership's basis of section 704(c)(1)(C) property. Thus, for purposes of calculating income, deduction, gain, and loss, the section 704(c)(1)(C) partner will have a special basis for section 704(c)(1)(C) property in which the partner has a section 704(c)(1)(C) basis adjustment. The section 704(c)(1)(C) basis adjustment has no effect on the partnership's computation of any item under section 703.

(B) *Computation of section 704(c)(1)(C) partner's distributive share of partnership items*. The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the section 704(c)(1)(C) partner, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the section 704(c)(1)(C) partner's distributive share of the items of partnership income, deduction, gain, or loss in accordance with paragraphs (f)(3)(ii)(C) and (D) of this section, to reflect the effects of the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment. These adjustments to the section 704(c)(1)(C) partner's distributive share must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). The adjustments to the section 704(c)(1)(C) partner's distributive shares do not affect the section 704(c)(1)(C) partner's capital account.

(C) *Effect of section 704(c)(1)(C) basis adjustment in determining items of income, gain, or loss*. The amount of a section 704(c)(1)(C) partner's income, gain, or loss from the sale or exchange of partnership property in which the section 704(c)(1)(C) partner has a section 704(c)(1)(C) basis adjustment is equal to the section 704(c)(1)(C) partner's share of the partnership's gain or loss from the sale of the property (including any remedial allocations under § 1.704–3(d)), minus the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment for the partnership property.

(D) *Effect of section 704(c)(1)(C) basis adjustment in determining items of deduction*—(*1*) *In general*. If section 704(c)(1)(C) property is subject to amortization under section 197, depreciation under section 168, or other cost recovery in the hands of the section 704(c)(1)(C) partner, the section 704(c)(1)(C) basis adjustment associated with the property is recovered in accordance with section 197(f)(2), section 168(i)(7), or another applicable Internal Revenue Code section. The amount of any section 704(c)(1)(C) basis adjustment that is recovered by the section 704(c)(1)(C) partner in any year is added to the section 704(c)(1)(C) partner's distributive share of the partnership's depreciation or amortization deductions for the year. The basis adjustment is adjusted under section 1016(a)(2) to reflect the recovery of the section 704(c)(1)(C) basis adjustment.

(*2*) *Example*. A contributes Property, with an adjusted basis of $12,000 and a fair market value of $5,000 on January 1 of the year of contribution, and B contributes $5,000 to PRS, a partnership. Prior to the contribution, A depreciates Property under section 168 over 10 years using the straight-line method and the half-year convention. On the contribution date, Property has 7.5 years remaining in its recovery period. Property is section 704(c)(1)(C) property, and A's section 704(c)(1)(C) basis adjustment is $7,000. PRS's basis in Property is $5,000 (fair market value) and, in accordance with section 168(i)(7), the depreciation is $667 per year ($5,000 divided by 7.5 years), which is shared equally between A and B. A's $7,000 section 704(c)(1)(C) basis adjustment is subject to depreciation of $933 per year in accordance with section 168(i)(7) ($7,000 divided by 7.5 years), which is taken into account by A.

(iii) *Transfer of section 704(c)(1)(C) partner's partnership interest*—(A) *General rule*. Except as provided in paragraph (f)(3)(iii)(B) of this section, if a section 704(c)(1)(C) partner transfers its partnership interest, the portion of the section 704(c)(1)(C) basis adjustment attributable to the interest transferred is eliminated and the transferee is not treated as the section 704(c)(1)(C) partner with respect to the interest transferred. The transferor remains the section 704(c)(1)(C) partner with respect to any remaining section 704(c)(1)(C) basis adjustment.

(B) *Special rules*—(*1*) *General rule for transfer of partnership interest in nonrecognition transaction*. Except as provided in paragraph (f)(3)(iii)(B)(*2*) of this section, paragraph (f)(3)(iii)(A) of this section does not apply to the extent a section 704(c)(1)(C) partner transfers its partnership interest in a nonrecognition transaction. Instead, the transferee of all or a portion of a section 704(c)(1)(C) partner's partnership interest succeeds to the transferor's section 704(c)(1)(C) basis adjustments in an amount attributable to the interest transferred and the transferee will be treated as the section 704(c)(1)(C) partner with respect to the transferred interest. Regardless of whether a section 754 election is in effect or a substantial built-in loss exists with respect to the transfer, the amount of any section 704(c)(1)(C) basis adjustment with respect to section 704(c)(1)(C) property to which the transferee succeeds shall be decreased by the amount of any negative section 743(b) adjustment that would be allocated to the section 704(c)(1)(C) property pursuant to the provisions of § 1.755–1 if the partnership had a section 754 election in effect upon the transfer. If the nonrecognition transaction is described in section 168(i)(7)(B), then the rules in section 168(i)(7)(A) apply with respect to transferor's cost recovery deductions under section 168. If gain or loss is recognized on the transaction, appropriate adjustments must be made to the section 704(c)(1)(C) basis adjustment.

(*2*) *Exception for gifts*. Paragraph (f)(3)(iii)(B)(*1*) of this section does not apply to the transfer of all or a portion of a section 704(c)(1)(C) partner's partnership interest by gift.

(C) *Examples*. The following examples illustrate the principles of this paragraph (f)(3)(iii)—

Example 1. Sale of entire partnership interest. In Year 1, A contributes non-depreciable Property, with an adjusted basis of $11,000 and a fair market value of $5,000, and B and C each contribute $5,000 cash to PRS, a partnership. PRS's basis in Property is $5,000, and A's section 704(c)(1)(C) basis adjustment in Property is $6,000. In Year 3, Property's fair market value is unchanged and A's section 704(c)(1)(C) basis adjustment remains $6,000. D purchases A's interest in PRS for its fair market value of $5,000. PRS does not have a section 754 election in effect in Year 3. A recognizes a loss of $6,000 on the sale, which equals the excess of its basis in PRS ($11,000) over the amount realized on the sale ($5,000). Pursuant to paragraph (f)(3)(iii)(A) of this section, D does not succeed to A's section 704(c)(1)(C) basis adjustment, which is eliminated upon the sale.

Example 2. Sale of portion of partnership interest. Assume the same facts as *Example 1* except that D purchases 50 percent of A's interest in PRS for its fair market value of $2,500. A recognizes a loss of $3,000 on the sale, which equals the excess of its basis in the 50 percent interest in PRS ($5,500) over the amount realized on the sale ($2,500). Pursuant to paragraph (f)(3)(iii)(A) of this section, D does not succeed to A's section 704(c)(1)(C) basis adjustment, and A's section 704(c)(1)(C) basis adjustment is reduced to $3,000 upon the sale.

Example 3. Section 721 transaction—(i) Assume the same facts as *Example 1* except that instead of selling its interest in PRS to D in Year 3, A contributes its interest in PRS to UTP, a partnership, in exchange for a 50 percent interest in UTP. Following the contribution, UTP's basis in PRS is $5,000 plus a $6,000 section 704(c)(1)(C) basis adjustment solely allocable to A. Under the facts of this example, UTP's share of basis in PRS property is the same.

(ii) Under paragraph (f)(3)(iii)(B)(*1*) of this section, UTP succeeds to A's $6,000 section 704(c)(1)(C) basis adjustment in Property. PRS does not have a section 754 election in effect and does not have a substantial built-in loss (within the meaning of § 1.743–1(a)(2)(i)) with respect to the transfer. Paragraph (f)(3)(iii)(B)(*1*) of this section requires PRS to reduce the amount of the section 704(c)(1)(C) basis adjustment by the amount of the negative section 743(b) adjustment that would be allocated to Property if PRS had an election under section 754 in effect. Because UTP's basis in PRS equals UTP's share of basis in PRS property, no negative section 743(b) adjustment would result from the transfer. Accordingly, UTP's section 704(c)(1)(C) basis adjustment in Property is $6,000. Pursuant to paragraph (a)(9) of this section, UTP must allocate its distributive share of PRS's items with respect to the section 704(c)(1)(C) basis adjustment solely to A.

(iii) In Year 3, PRS sells Property for its fair market value of $5,000. PRS realizes no gain or loss on the sale. Pursuant to paragraph (f)(3)(ii)(C) of this section, PRS reduces UTP's allocable gain from the sale of Property ($0) by the amount of UTP's section 704(c)(1)(C) basis adjustment for Property ($6,000). Thus, UTP is allocated a $6,000 loss. Pursuant to paragraph (a)(9) of this section, UTP must allocate the $6,000 loss with respect to the section 704(c)(1)(C) basis adjustment to A. A's basis in UTP decreases from $11,000 to $5,000 and its section 704(c)(1)(C) basis adjustment in UTP is eliminated.

Example 4. Interaction with section 362(e)(2)(A)—(i) Assume the same facts as *Example 1* except that instead of selling its interest in PRS to D in Year 3, A contributes its interest in PRS to Y Corp, a corporation, in a transfer described in section 351. PRS has a section 754 election in effect. A's basis in its Y Corp stock is $11,000 under section 358.

(ii) A and Y Corp do not elect to apply the provisions of section 362(e)(2)(C). Therefore, section 362(e)(2)(A) will apply because Y Corp's basis in PRS ($11,000) would exceed the fair market value of PRS ($5,000) immediately after the transaction. Thus, pursuant to section 362(e)(2)(B), Y Corp's basis in PRS will be $5,000. Y Corp succeeds to A's $6,000 section 704(c)(1)(C) basis adjustment in Property pursuant to paragraph (f)(3)(iii)(B)(*1*) of this section. Pursuant to § 1.743–1, Y Corp's section 743(b) adjustment is ($6,000), or the difference between Y Corp's basis in PRS of $5,000 and Y Corp's share of the adjusted basis of PRS's property of $11,000 (which is Y Corp's cash on liquidation of $5,000, increased by the $6,000 tax loss that would be allocated to Y Corp upon a hypothetical transaction). The ($6,000) section 743(b) adjustment will be allocated to PRS's property in accordance with section 755 and the regulations thereunder.

Example 5. Gift of partnership interest. Assume the same facts as *Example 1* except that instead of selling its PRS interest to D in Year 3, A makes a gift of its PRS interest to D. Pursuant to paragraph (f)(3)(iii)(B)(*2*) of this section, D does not succeed to any of A's section 704(c)(1)(C) basis adjustment in Property. The $6,000 section 704(c)(1)(C) basis adjustment is eliminated upon the gift.

(iv) *Transfer of section 704(c)(1)(C) property by partnership*—(A) *Like-kind exchange*—(*1*) *General rule*. If a partnership disposes of section 704(c)(1)(C) property in a like-kind exchange described in section 1031 and the regulations thereunder, the substituted basis property (as defined in section 7701(a)(42)) received by the partnership is treated, solely with respect to the section 704(c)(1)(C) partner, as section 704(c)(1)(C) property with the same section 704(c)(1)(C) basis adjustment as the section 704(c)(1)(C) property disposed of by the partnership (with appropriate adjustments for any portion of the section 704(c)(1)(C) basis adjustment taken into account in determining the section 704(c)(1)(C) partner's gain or loss recognized on the transfer).

(*2*) *Example*. A contributes Property 1 with an adjusted basis of $12,000 and a fair market value of $10,000 and B contributes $10,000 cash to PRS, a partnership. A has a $2,000 section 704(c)(1)(C) basis adjustment in Property 1, and PRS has an adjusted basis in Property 1 of $10,000, or its fair market value. PRS subsequently engages in a like-kind exchange under section 1031 of Property 1 when the fair market value of Property 1 is $13,000 and receives Property 2 with a fair market value of $12,000 and $1,000 cash in exchange. PRS's gain on the transaction is $3,000 ($13,000 minus PRS's $10,000 adjusted basis) but is recognized only to the extent of the cash received of $1,000, of which $500 is allocable to A. As provided in paragraph (f)(3)(iv)(A)(*1*) of this section, Property 2 is treated as section 704(c)(1)(C) property with respect to A and has the same section 704(c)(1)(C) basis adjustment as Property 1. Because PRS recognized gain on the transaction, A must use $500 of its section 704(c)(1)(C) basis adjustment to reduce A's gain to $0. Therefore, A's $2,000 section 704(c)(1)(C) basis adjustment is reduced to $1,500.

(B) *Contribution of 704(c)(1)(C) property in section 721 transaction*—(*1*) *In general*. The rules set forth in this paragraph (f)(3)(iv)(B) apply if a section 704(c)(1)(C) partner contributes section 704(c)(1)(C) property to an upper-tier partnership, and that upper-tier partnership subsequently contributes the section 704(c)(1)(C) property to a lower-tier partnership in a transaction described in section 721(a) (whether as part of a single transaction or as separate transactions). The interest in the lower-tier partnership received by the upper-tier partnership is treated as the section 704(c)(1)(C) property with the same section 704(c)(1)(C) basis adjustment as the contributed property. The lower-tier partnership determines its basis in the contributed property by excluding the existing section 704(c)(1)(C) basis adjustment under the principles of paragraph (f)(3)(ii)(A) of this section. However, the lower-tier partnership also succeeds to the upper-tier partnership's section 704(c)(1)(C) basis adjustment. The portion of the upper-tier partnership's basis in its interest in the lower-tier partnership attributable to the section 704(c)(1)(C) basis adjustment must be segregated and allocated solely to the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made. Similarly, the section 704(c)(1)(C) basis adjustment to which the lower-tier partnership succeeds must be segregated and allocated solely to the upper-tier partnership, and the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made. If gain or loss is recognized on the transaction, appropriate adjustments must be made to the section 704(c)(1)(C) basis adjustment.

(*2*) *Special rules*. (*a*) To the extent that any section 704(c)(1)(C) basis adjustment in a tiered partnership is recovered under paragraphs (f)(3)(ii)(C) or (D) of this section, or is otherwise reduced, upper- or lower-tier partnerships in the tiered structure must make conforming reductions to related section 704(c)(1)(C) basis adjustments to prevent duplication of loss.

(*b*) Section 704(c)(1)(C) property that is contributed by an upper-tier partnership to a lower-tier partnership will have an additional section 704(c)(1)(C) basis adjustment if the value of the section 704(c)(1)(C) property is less than its tax basis (as adjusted under paragraph (f)(3)(ii) of this section) at the time of the transfer to the lower-tier partnership. Any additional section 704(c)(1)(C) basis adjustment determined under this paragraph will be allocated among the partners of the upper-tier partnership in a manner that reflects their relative shares of that loss.

(*3*) *Example 1*—(i) In Year 1, A contributes Property with an adjusted basis of $11,000 and a fair market value of $5,000, and B contributes $5,000 cash to UTP, a partnership. Later in Year 1, when Property's basis has not changed, and Property is worth at least $5,000, UTP contributes Property to LTP in a section 721 transaction for a 50-percent interest in LTP. In Year 2, LTP sells Property for its fair market value of $29,000.

(ii) A has a $6,000 section 704(c)(1)(C) basis adjustment in Property. After the section 721 transaction, A's section 704(c)(1)(C) basis adjustment in Property becomes A's section 704(c)(1)(C) adjustment in UTP's interest in LTP. UTP has a section 704(c)(1)(C) adjustment in Property in the amount of A's section 704(c)(1)(C) adjustment in Property. This section 704(c)(1)(C) adjustment must be segregated and allocated solely to A. UTP's basis in its interest in LTP is determined without reference to the section 704(c)(1)(C) adjustment. Thus, UTP's basis in LTP is $5,000. LTP's basis in Property is determined without reference to the section 704(c)(1)(C) basis adjustment; therefore, LTP's basis in Property is $5,000.

(iii) Upon the sale of Property, LTP realizes a gain of $24,000 ($29,000 fair market value minus $5,000 adjusted basis). UTP's allocable share of the $24,000 gain from the sale of Property by LTP is $12,000, reduced by UTP's $6,000 section 704(c)(1)(C) basis adjustment in Property. Because UTP's section 704(c)(1)(C) basis adjustment must be segregated and allocated solely to A, UTP allocates the $12,000 of gain equally between A and B, but allocates the recovery of the $6,000 section 704(c)(1)(C) basis adjustment to A. Therefore, pursuant to paragraph (f)(3)(ii)(C) of this section, A recognizes no gain or loss on the sale (A's $6,000 share of UTP's gain minus the $6,000 section 704(c)(1)(C) basis adjustment). Because UTP's section 704(c)(1)(C) adjustment in Property is used, A's section 704(c)(1)(C) basis adjustment in UTP's interest in LTP is reduced to $0 to prevent duplication of loss pursuant to paragraph (f)(3)(iv)(B)(*2*)(*a*) of this section.

Example 2— Assume the same facts as *Example 1*, except that in Year 2, UTP sells its entire interest in LTP to D for its fair market value of $17,000. UTP recognizes a $12,000 gain on the sale, which equals the excess of UTP's amount realized on the sale ($17,000) over UTP's basis in LTP ($5,000). UTP allocates the $12,000 gain equally to A and B. However, A's $6,000 section 704(c)(1)(C) adjustment in UTP's interest in LTP offsets A's share of the gain. Therefore, A recognizes no gain or loss on the sale. D does not receive any of UTP's section 704(c)(1)(C) basis adjustment in Property, which is eliminated upon the sale.

Example 3—(i) Assume the same facts as *Example 1*, except that at the time UTP contributes Property to LTP, the fair market value of Property has fallen to $2,000. In Year 2, LTP sells Property for its fair market value of $2,000.

(ii) A has a $6,000 section 704(c)(1)(C) basis adjustment in Property. After the section 721 transaction, pursuant to paragraph (f)(3)(iv)(B)(*1*) of this section, A's section 704(c)(1)(C) basis adjustment in Property becomes A's section 704(c)(1)(C) adjustment in UTP's interest in LTP. Pursuant to paragraph (f)(3)(iv)(B)(*1*) of this section, UTP has a section 704(c)(1)(C) adjustment in Property in the amount of A's section 704(c)(1)(C) adjustment in Property. This section 704(c)(1)(C) adjustment must be segregated and allocated solely to A. Because UTP's basis in Property ($5,000) exceeds the fair market value of Property ($2,000) by $3,000 at the time of UTP's contribution to LTP, UTP has an additional section 704(c)(1)(C) adjustment of $3,000 in Property pursuant to paragraph (f)(3)(iv)(B)(*2*)(*b*) of this section. Partners A and B share equally in this $3,000 section 704(c)(1)(C) adjustment. UTP's basis in its interest in LTP is determined without reference to A's section 704(c)(1)(C) adjustment. Thus, UTP's basis in LTP is $5,000. Pursuant to paragraph (f)(3)(iv)(B)(*1*) of this section, LTP's basis in Property is determined without reference to either section 704(c)(1)(C) basis adjustment; therefore, LTP's basis in Property is $2,000.

(iii) Upon the sale of Property, LTP recognizes no gain or loss ($2,000 sales price minus $2,000 adjusted basis). However, the sale of Property triggers UTP's two separate section 704(c)(1)(C) basis adjustments. First, UTP applies the $3,000 section 704(c)(1)(C) adjustment attributable to the built-in loss in Property arising after A contributed Property to UTP. This results in an allocation of ($1,500) of loss to each of A and B. Next, UTP applies the $6,000 section 704(c)(1)(C) basis adjustment attributable to A's initial contribution of Property to UTP, resulting in an additional ($6,000) of loss allocated to A. Thus, the sale of Property by LTP results in A recognizing ($7,500) of loss, and B recognizing ($1,500) of loss. Pursuant to paragraph (f)(3)(iv)(B)(*2*)(*a*) of this section, because UTP's section 704(c)(1)(C) adjustment in Property is used, A's section 704(c)(1)(C) basis adjustment in UTP's interest in LTP is reduced to $0 to prevent duplication of loss

(C) *Section 351 transactions*—(*1*) *Basis in transferred property*. A corporation's adjusted basis in property transferred to the corporation by a partnership in a transaction described in section 351 is determined under section 362 (including for purposes of applying section 362(e)) by taking into account any section 704(c)(1)(C) basis adjustment for the property (other than any portion of a section 704(c)(1)(C) basis adjustment that reduces a partner's gain under paragraph (f)(3)(iv)(C)(*2*) of this section).

(*2*) *Partnership gain*. The amount of gain, if any, recognized by the partnership on the transfer of property by the partnership to a corporation in a transfer described in section 351 is determined without regard to any section 704(c)(1)(C) basis adjustment for the transferred property. The amount of gain, if any, recognized by the partnership on the transfer that is allocated to the section 704(c)(1)(C) partner is adjusted to reflect the partner's section 704(c)(1)(C) basis adjustment in the transferred property.

(*3*) *Basis in stock*. The partnership's adjusted basis in stock received from a corporation in a transfer described in section 351 is determined without regard to the section 704(c)(1)(C) basis adjustment in property transferred to the corporation in the section 351 exchange. A partner with a section 704(c)(1)(C) basis adjustment in property transferred to the corporation, however, has a basis adjustment in the stock received by the partnership in the section 351 exchange in an amount equal to the partner's section 704(c)(1)(C) basis adjustment in the transferred property, reduced by any portion of the section 704(c)(1)(C) basis adjustment that reduced the partner's gain under paragraph (f)(3)(iv)(C)(*2*) of this section.

(*4*) *Example*. The following example illustrates the provisions of this paragraph (f)(3)(iv)(C).

Example. Section 351 transaction—(i) In Year 1, A contributes $10,000 cash and B contributes Property with an adjusted basis of $18,000 and a fair market value of $10,000 to PRS, a partnership. PRS takes Property with a basis of $10,000. B's section 704(c)(1)(C) basis adjustment for Property is $8,000. PRS contributes Property to Y Corp in a section 351 transaction. Under section 362(e)(2)(A), Y Corp takes a $10,000 basis in Property. PRS's basis in its Y Corp stock is $10,000 under section 358. Pursuant to paragraph (f)(3)(iv)(C)(*3*) of this section, B has a section 704(c)(1)(C) basis adjustment of $8,000 in the Y Corp stock received by PRS in the section 351 exchange.

(ii) In Year 2, Y Corp sells Property for its fair market value of $10,000. Y Corp recognizes no gain or loss on the sale of Property. Pursuant to paragraph (f)(3)(iv)(C)(*1*) of this section, B does not take into account its section 704(c)(1)(C) basis adjustment upon the sale by Y Corp of Property. Instead, B will take the section 704(c)(1)(C) basis adjustment into account when PRS disposes of the Y Corp stock.

(D) *Section 708(b)(1)(B) transactions*—(*1*) *In general*. A partner with a section 704(c)(1)(C) basis adjustment in section 704(c)(1)(C) property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same section 704(c)(1)(C) basis adjustment for section 704(c)(1)(C) property deemed contributed by the terminated partnership to the new partnership under § 1.708–1(b)(4). In addition, the deemed contribution of property by a terminated partnership to a new partnership is not subject to this section and does not create a section 704(c)(1)(C) basis adjustment.

(2) *Example*. A contributes Property with an adjusted basis of $11,000 and a fair market value of $5,000 and B contributes $5,000 cash to PRS, a partnership. B sells its entire interest in PRS to C for its fair market value of $5,000, which terminates PRS under section 708(b)(1)(B). Under § 1.708–1(b)(4), PRS is deemed to contribute all of its assets and liabilities to a new partnership (New PRS) in exchange for an interest in New PRS. Immediately thereafter, PRS is deemed to distribute its interest in New PRS equally to A and C in complete liquidation of PRS. New PRS takes Property with a basis of $5,000 and A retains its $6,000 section 704(c)(1)(C) basis adjustment related to Property inside New PRS.

(E) *Disposition in an installment sale*. If a partnership disposes of section 704(c)(1)(C) property in an installment sale (as defined in section 453(b)), the installment obligation received by the partnership is treated as the section 704(c)(1)(C) property with the same section 704(c)(1)(C) basis adjustment as the section 704(c)(1)(C) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale).

(F) *Contributed contracts*. If a partner contributes to a partnership a contract that is section 704(c)(1)(C) property, and the partnership subsequently acquires property pursuant to the contract in a transaction in which less than all of the loss is recognized, then the acquired property is treated as section 704(c)(1)(C) property with the same section 704(c)(1)(C) basis adjustment as the contract (with appropriate adjustments for any gain or loss recognized on the acquisition). For this purpose, the term *contract* includes, but is not limited to, options, forward contracts, and futures contracts.

(v) *Distributions*—(A) *Current distribution of section 704(c)(1)(C) property to section 704(c)(1)(C) partner*. If a partnership distributes property to a partner and the partner has a section 704(c)(1)(C) basis adjustment for the property, the section 704(c)(1)(C) basis adjustment is taken into account under section 732. *See* § 1.732–2(a). For certain adjustments to the basis of remaining partnership property after the distribution of section 704(c)(1)(C) property to the section 704(c)(1)(C) partner, see § 1.734–2(c).

(B) *Distribution of section 704(c)(1)(C) property to another partner*. If a partner receives a distribution of property in which another partner has a section 704(c)(1)(C) basis adjustment, the distributee does not take the section 704(c)(1)(C) basis adjustment into account under section 732. If section 704(c)(1)(B) applies to treat the section 704(c)(1)(C) partner as recognizing loss on the sale of the distributed property, the section 704(c)(1)(C) basis adjustment is taken into account in determining the amount of the loss. A section 704(c)(1)(C) partner with a section 704(c)(1)(C) basis adjustment in the distributed property that is not taken into account as described in the prior sentence reallocates the section 704(c)(1)(C) basis adjustment among the remaining items of partnership property under § 1.755–1(c).

(C) *Distributions in complete liquidation of a section 704(c)(1)(C) partner's interest*. If a section 704(c)(1)(C) partner receives a distribution of property (whether or not the partner has a section 704(c)(1)(C) basis adjustment in the property) in liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment for the property in which the section 704(c)(1)(C) partner relinquished an interest. For purposes of determining the section 704(c)(1)(C) partner's basis in distributed property under section 732, the partnership reallocates any section 704(c)(1)(C) basis adjustment from section 704(c)(1)(C) property retained by the partnership to distributed properties of like character under the principles of § 1.755–1(c)(i), after applying sections 704(c)(1)(B) and 737. If section 704(c)(1)(C) property is retained by the partnership, and no property of like character is distributed, then that property's section 704(c)(1)(C) basis adjustment is not reallocated to the distributed property for purposes of applying section 732. *See* § 1.734–2(c)(2) for rules regarding the treatment of any section 704(c)(1)(C) adjustment that is not fully utilized by the section 704(c)(1)(C) partner.

(D) *Examples*. The following examples illustrate the principles of this paragraph (f)(3)(v).

Example 1. Current distribution of section 704(c)(1)(C) property to section 704(c)(1)(C) partner—(i) A contributes Property 1 with an adjusted basis of $15,000 and a fair market value of $10,000 and Property 2 with an adjusted basis of $5,000 and a fair market value of $20,000 and B contributes $30,000 cash to PRS, a partnership. Property 1 and Property 2 are both capital assets. When Property 1 has a fair market value of $12,000, and neither A nor B's basis in PRS has changed, PRS distributes Property 1 to A in a current distribution.

(ii) Property 1 has an adjusted basis to PRS of $10,000, and A has a section 704(c)(1)(C) basis adjustment of $5,000 in Property 1. Pursuant to § 1.732–2(c) and paragraph (f)(3)(v)(A) of this section, for purposes of section 732(a)(1), the adjusted basis of Property 1 to PRS immediately before the distribution is $15,000 (PRS's $10,000 adjusted basis increased by A's $5,000 section 704(c)(1)(C) basis adjustment for Property 1) and, therefore A takes a $15,000 adjusted basis in Property 1 upon the distribution. Accordingly, no adjustment is required to PRS's property under section 734.

Example 2. Current distribution of section 704(c)(1)(C) property to another partner. Assume the same facts as *Example 1* except PRS distributes Property 1 to B in a distribution to which section 704(c)(1)(B) does not apply. B does not take any portion of A's section 704(c)(1)(C) basis adjustment into account. Accordingly, pursuant to § 1.732–1(a) and paragraph (f)(3)(v)(B) of this section, for purposes of section 732(a)(1), the adjusted basis of Property 1 to PRS immediately before the distribution is $10,000 and, therefore, B takes a $10,000 adjusted basis in Property 1 upon the distribution. Accordingly, no adjustment is required to PRS's property under section 734. A's section 704(c)(1)(C) basis adjustment in Property 1 is reallocated to Property 2 in accordance with § 1.755–1(c).

Example 3. (i) *Liquidating distribution to section 704(c)(1)(C) partner*. In Year 1, A contributes Property 1 with an adjusted basis of $15,000 and a fair market value of $10,000 and Property 2 with an adjusted basis of $5,000 and a fair market value of $20,000 and B and C each contribute $30,000 cash to PRS, a partnership. Property 1 and Property 2 are both capital assets. In a later year, when the fair market value of Property 2 is still $20,000, and no partner's basis in PRS has changed, PRS distributes Property 2 and $10,000 to A in complete liquidation of A's partnership interest in a distribution to which section 737 does not apply. PRS has a section 754 election in effect for the year of the distribution.

(ii) Property 2 has an adjusted basis to PRS of $5,000, and A has a section 704(c)(1)(C) basis adjustment of $5,000 in Property 1. Pursuant to § 1.732–2(c) and paragraph (f)(3)(v)(C) of this section, for purposes of section 732(b), the adjusted basis of Property 2 to PRS immediately before the distribution is $10,000 (PRS's $5,000 adjusted basis in Property 2 increased by A's $5,000 section 704(c)(1)(C) basis adjustment for Property 1), and A's adjusted basis in Property 2 upon the distribution is $10,000 (A's $20,000 basis in PRS minus the $10,000 cash distributed). Therefore, no adjustment is required to PRS's property under section 734.

(vi) *Returns*. A partnership that owns property with a section 704(c)(1)(C) basis adjustment must attach a statement to the partnership return for the year of the contribution setting forth the name and taxpayer identification number of the section 704(c)(1)(C) partner as well as the section 704(c)(1)(C) basis adjustment and the section 704(c)(1)(C) property to which the adjustment relates.

(g) * * *. The provisions of paragraph (f) of this section apply to partnership contributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 3. Section 1.704–4 is amended as follows:

1. In paragraph (a)(1), by removing "five years" and adding in its place "seven years".
2. In paragraph (a)(4) by removing "five-year" and adding in its place "seven-year" each time it appears.
3. By revising paragraph (a)(4)(i).
4. In paragraph (f)(2), *Examples 1* and *2*, by removing the phrase "five-year" and adding in its place "seven-year" each time it appears and removing "2000" and adding in its place "2002" each time it appears.
5. By adding a sentence to the end of paragraph (g).

The revision and addition read as follows:

§ 1.704–4 Distribution of contributed property.

(a) * * *

(4) *Determination of seven-year period*—(i) *General rule*. The seven-year period specified in paragraph (a)(1) of this section begins on, and includes, the date of contribution and ends on, and includes, the last date that is within seven years of the contribution. For example, if a partner contributes section 704(c) property to a partnership on May 15, 2016, the seven-year period with respect to the section 704(c) property ends on, and includes, May 14, 2023.

* * * * *

(g) * * * The provisions of this section relating to the seven-year period for determining the applicability of section 704(c)(1)(B) are applicable for partnership contributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 4. Section 1.732–2 is amended by:

1. Redesignating paragraph (b) introductory text as (b)(1) introductory text and revising it.
2. Adding paragraph (b)(2).
3. Redesignating paragraph (c) as paragraph (d).
4. Adding a new paragraph (c).

The revisions and addition reads as follows:

§ 1.732–2 Special partnership basis of distributed property.

* * * * *

(b) *Adjustments under section 743(b)*—(1) *In general*. In the case of a distribution of property to a partner who acquired any part of its interest in a transfer, if there was an election under section 754 in effect with respect to the transfer, or if the partnership had a substantial built-in loss (as defined in § 1.743–1(a)(2)(i)) immediately after the transfer, then, for purposes of section 732 (other than subsection (d) thereof), the adjusted partnership basis of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

* * * * *

(2) *Effective/applicability date*. Paragraph (b)(1) of this section relating to substantial built-in losses is applicable for partnership distributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(c) *Adjustments under section 704(c)(1)(C)*—(1) *In general*. In the case of a distribution of property to a section 704(c)(1)(C) partner (as defined in § 1.704–3(f)(2)(ii)), for purposes of section 732 (other than subsection (d) thereof), the adjusted partnership basis of the distributed property shall take into account, in addition to any adjustments under section 734(b), the distributee's section 704(c)(1)(C) basis adjustment (if any) for the distributed property.

(2) *Effective/applicability date*. Paragraph (c)(1) of this section is applicable for partnership distributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

Par. 5. Section 1.734–1 is amended by:

1. Revising the section heading.
2. Revising paragraph (a).
3. Revising paragraph (b)(2)(i).
4. Adding *Example 3 following paragraph (b)(2)(ii)*.
5. Adding a sentence at the end of paragraph (d).
6. Adding paragraphs (f), (g), and (h).

The revisions and additions read as follows:

§ 1.734–1 Adjustment to basis of undistributed partnership property where partnership has a section 754 election or there is a substantial basis reduction with respect to a distribution.

(a) *General rule*—(1) *Adjustments to basis*. A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect or there is a substantial basis reduction (within the meaning of paragraph (a)(2)(i) of this section) with respect to the distribution.

(2) *Substantial basis reduction*—(i) *In general*. For purposes of this section, there is a substantial basis reduction with respect to a distribution of property or properties to a partner if the sum of the amounts described in section 734(b)(2)(A) and (b)(2)(B) exceeds $250,000. If there is a substantial basis reduction under this section, the partnership is treated as having an election under section 754 in effect solely for the distribution to which the substantial basis reduction relates.

(ii) *Special rules for tiered partnerships*. See paragraph (f) of this section for special rules regarding tiered partnerships.

(iii) *Special rules for securitization partnerships*. See paragraph (g) of this section for special rules regarding securitization partnerships.

(b) * * *

(2) *Decrease in basis*. (i) When a partnership with a section 754 election in effect makes a distribution in liquidation of a partner's entire interest in the partnership, or when there is a substantial basis reduction (within the meaning of paragraph (a)(2)(i) of this section), the partnership shall decrease the adjusted basis

of the remaining partnership property by—

(ii) * * *

Example 3—(i) A, B, and C each contribute $2 million to PRS, a partnership. PRS purchases Property 1 and Property 2, both of which are capital assets, for $1 million and $5 million respectively. In Year 2, the fair market value of Property 1 increases to $3 million and the fair market value of Property 2 increases to $6 million. Also in Year 2, PRS distributes Property 1 to C in liquidation of C's interest in PRS at a time when C's basis in its PRS interest is still $2 million. PRS does not have an election under section 754 in effect.

(ii) Under section 732, the basis of Property 1 in the hands of C is $2 million. Because the excess of C's adjusted basis in Property 1 ($2 million) over PRS's adjusted basis in Property 1 ($1 million) is $1 million, the amount described in section 734(b)(2)(B) ($1 million) exceeds $250,000, and therefore, there is a substantial basis reduction with respect to the distribution. Accordingly, pursuant to paragraph (a)(2)(i) of this section, PRS is treated as having a section 754 election in effect in Year 2 and must reduce its basis in Property 2 in accordance with paragraph (b)(2)(i) of this section.

* * * * *

(d) * * * A partnership required to adjust the basis of partnership property following the distribution of property because there is a substantial basis reduction (within the meaning of paragraph (a)(2)(i) of this section) with respect to the distribution is subject to, and required to comply with, the provisions of this paragraph (d) solely with respect to the distribution to which the substantial basis reduction relates.

* * * * *

(f) *Adjustments with respect to tiered partnerships*—(1) *In general*. If an upper-tier partnership makes an adjustment under paragraph (b) of this section to the basis of an interest it holds in a lower-tier partnership that has an election under section 754 in effect, the lower-tier partnership must make adjustments under paragraph (b) of this section to the upper-tier partnership's share of the lower-tier partnership's assets. The amount of the lower-tier partnership's adjustment is equal to the adjustment made by the upper-tier partnership to the basis of its interest in the lower-tier partnership. The lower-tier partnership's adjustment to the upper-tier partnership's share of its assets is for the upper-tier partnership only and does not affect the basis in the lower-tier partnership's property for the other partners of the lower-tier partnership. Additionally, if there is a substantial basis reduction (within the meaning of paragraph (a)(2)(i) of this section) with respect to a distribution by an upper-tier partnership that (either directly or indirectly through one or more partnerships) holds an interest in a lower-tier partnership, each lower-tier partnership is treated, solely with respect to the distribution, as if it had made an election under section 754 for the taxable year in which the distribution occurs. For additional examples of the application of the principles of this paragraph (f)(1), see Revenue Ruling 92–15, 1992–1 CB 215. *See* § 601.601(d)(2)(ii)(b)

(2) *Example*—(i) *Facts*. A, B, and C are equal partners in UTP, a partnership. Each partner's interest in UTP has an adjusted basis and fair market value of $3 million. UTP owns two capital assets with the following adjusted bases and fair market values:

	Adjusted basis	Fair market value
Property 1	$2.2 million	$3 million
Property 2	$2.8 million	$3 million

UTP also owns a 50 percent interest in LTP, a partnership. UTP's interest in LTP has an adjusted basis of $4 million and a fair market value of $3 million. LTP owns one asset, Property 3, a capital asset, which has an adjusted basis of $8 million and a fair market value of $6 million. Neither UTP nor LTP has an election under section 754 in effect.

(ii) *Liquidating distribution to A of Property 1*. UTP distributes Property 1 to A in complete liquidation of A's interest in UTP. Under section 732(b), the adjusted basis of Property 1 to A is $3 million. Therefore, there is a substantial basis reduction with respect to the distribution to A because the sum of the amounts described in section 734(b)(2)(A) ($0) and section 734(b)(2)(B) (the excess of $3 million over $2.2 million, or $800,000) exceeds $250,000. Therefore, pursuant to paragraph (b)(2) of this section, UTP must decrease the basis of its property by $800,000. Under § 1.755–1(c), UTP must decrease the adjusted basis of its 50 percent interest in LTP by $800,000. Likewise, pursuant to paragraph (f)(1) of this section, LTP must decrease its basis in UTP's share of Property 3 by $800,000 in accordance with § 1.755–1(c).

(g) *Securitization partnerships*. A securitization partnership (as defined in § 1.743–1(o)(2)) shall not be treated as having a substantial basis reduction with respect to any distribution of property to a partner.

(h) *Effective/applicability date*. The rules relating to substantial basis reductions in paragraphs (a) and (b) of this section and paragraphs (f) and (g) of this section apply to partnership distributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 6. Section 1.734–2 is amended by revising the section heading and adding paragraph (c) to read as follows:

§ 1.734–2 Adjustment after distribution to transferee partner or section 704(c)(1)(C) partner.

* * * * *

(c)(1) Section 704(c)(1)(C) basis adjustments will be taken into account in determining the basis adjustment under section 734(b). However, section 704(c)(1)(C) basis adjustments, other than a section 704(c)(1)(C) basis adjustment applied as an adjustment to the basis of partnership property pursuant to paragraph (c)(2) of this section, will not be taken into account in making allocations under § 1.755–1(c).

(2) *Liquidating distributions*. If a section 704(c)(1)(C) partner receives a distribution of property (including money) in liquidation of its entire partnership interest, the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustments that are treated as basis in the distributed property pursuant to section 732 will be taken into account in determining the basis adjustment under section 734(b), regardless of whether the distributed property is section 704(c)(1)(C) property. If any section 704(c)(1)(C) basis adjustment cannot be reallocated to distributed property in connection with the distribution, then that remaining section 704(c)(1)(C) basis adjustment shall be treated as a positive section 734(b) adjustment. If the distribution also gives rise to a negative section 734(b) adjustment without regard to the section 704(c)(1)(C) basis adjustment reallocation, then the negative section 734(b) adjustment and the section 704(c)(1)(C) basis adjustment reallocation are netted together, and the net amount is allocated under § 1.755–1(c). If the partnership does not have a section 754 election in effect at the time of the liquidating distribution, the partnership shall be treated as having made a section 754 election solely for purposes of computing any negative section 734(b) adjustment that would arise from the distribution.

(3) The following examples illustrate the provisions of this paragraph (c).

Example 1—(i) In Year 1, A contributes $5,000 cash and Property A, a capital asset, with an adjusted basis of $7,000 and a fair market value of $5,000; B contributes $8,000 cash and Property B, a capital asset, with an adjusted basis and fair market value of $2,000; and C contributes $7,000 cash and Property C, a capital asset, with an adjusted basis and fair market value of $3,000 to PRS, a partnership. In Year 3, Property B has appreciated in value to $8,000. PRS distributes Property B and $4,000 to C in complete liquidation of C's interest in PRS at a time when no partner's basis in PRS has changed. PRS revalues its property under § 1.704–1(b)(2)(iv)(*f*) in connection with the distribution, and makes an election under section 754. C recognizes no gain or loss on the distribution.

(ii) C receives Property B with a basis of $6,000 (C's adjusted basis in PRS of $10,000 minus the $4,000 cash distributed). Because PRS has an election under section 754 in effect, PRS must reduce its basis in remaining partnership property under § 1.734–1(b)(2)(ii) by $4,000 (C's $6,000 basis in Property B minus PRS's $2,000 adjusted basis in Property B prior to the distribution. Under § 1.755–1(c)(2)(ii), that basis reduction must be allocated within a class first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation. Any remaining decrease must be allocated in proportion to the properties' adjusted bases. Because there is no unrealized depreciation in either Property A (disregarding A's section 704(c)(1)(C) basis adjustment) or Property C, the decrease must be allocated between the two properties in proportion to their adjusted bases, $2,500 ($4,000 multiplied by $5,000 divided by $8,000) to Property A and $1,500 ($4,000 multiplied by $3,000 divided by $8,000) to Property C.

(iii) In a subsequent year, PRS sells Property A for its fair market value of $7,500 and recognizes $5,000 of gain ($7,500 amount realized minus adjusted basis of $2,500). Pursuant to § 1.704–3(f)(3)(ii)(B), A's $2,500 distributive share of the $5,000 gain from the sale of Property A is reduced by A's $2,000 section 704(c)(1)(C) basis adjustment. Therefore, A recognizes a gain of $500 on the sale.

Example 2—(i) A contributes Property 1 with an adjusted basis of $15,000 and a fair market value of $10,000 and Property 2 with an adjusted basis of $15,000 and a fair market value of $20,000, and B and C each contribute $30,000 cash to PRS, a partnership. A has a section 704(c)(1)(C) basis adjustment of $5,000 with respect to Property 1. PRS's adjusted bases in Property 1 and Property 2 are $10,000 and $15,000, respectively. When the fair market value of A's interest in PRS is still $30,000, and no partner's basis in its PRS interest has changed, PRS makes a liquidating distribution to A of $30,000 cash, which results in A realizing no gain or loss. PRS has an election under section 754 in effect.

(ii) A is unable to take into account A's section 704(c)(1)(C) basis adjustment in Property 1 upon the distribution of the cash as described in paragraph (c)(2) of this section because A cannot increase the basis of cash under § 1.704–3(f)(3)(v)(C). Thus, A's $5,000 section 704(c)(1)(C) basis adjustment is treated as a positive section 734(b) adjustment to the partnership's assets retained. PRS's $5,000 section 734(b) adjustment will be allocated to Property 2, increasing its basis from $15,000 to $20,000 under § 1.755–1(c).

Example 3—(i) A contributes Property 1 with an adjusted basis of $35,000 and a fair market value of $30,000, B contributes Property 2 with an adjusted basis and fair market value of $30,000, and C contributes $30,000 cash to PRS, a partnership. Property 1 is a capital asset, and Property 2 is inventory (as defined in section 751(d)). PRS's adjusted basis in Property 1 is $30,000 under section 704(c)(1)(C)(ii), and A has a section 704(c)(1)(C) basis adjustment of $5,000 with respect to Property 1. Later, at a time when the value and bases of the properties have not changed, PRS distributes $30,000 cash to A in complete liquidation of A's interest. A recognizes a ($5,000) loss under section 731(a)(2) on the distribution. PRS has an election under section 754 in effect.

(ii) The distribution results in a negative section 734(b) adjustment to capital gain property of ($5,000) (the amount of loss A recognizes under section 731(a)(2)). Additionally, because A is unable to take into account A's section 704(c)(1)(C) basis adjustment in Property 1 upon the distribution of the cash, A's $5,000 section 704(c)(1)(C) basis adjustment is treated as a positive section 734(b) adjustment. Pursuant to paragraph (c)(2) of this section, these two adjustments are netted together, resulting in no adjustment under section 734(b). Therefore, the partnership's basis in Property 1 and Property 2 remains $30,000.

Example 4—(i) Assume the same facts as in *Example 3* except that PRS distributes Property 2 to A in complete liquidation of A's interest in a transaction to which section 704(c)(1)(B) and section 737 do not apply.

(ii) Pursuant to § 1.704–3(f)(v)(C), A cannot include A's section 704(c)(1)(C) basis adjustment in the basis of the distributed property, because the section 704(c)(1)(C) property and the distributed property are not of like character. Accordingly, the basis to A of Property 2 is $30,000. A also recognizes a $5,000 capital loss under section 731(a)(2), resulting in a ($5,000) basis adjustment under section 734(b). Because the section 704(c)(1)(C) basis adjustment to Property 1 was not reallocated in connection with the distribution, that remaining $5,000 section 704(c)(1)(C) basis adjustment is treated as a positive section 734(b) adjustment. Pursuant to paragraph (c)(2) of this section, these two adjustments are netted together, resulting in no adjustment under section 734(b). Therefore, the basis of Property 1 remains $30,000.

(4) *Effective/applicability date*. This paragraph (c) applies to partnership distributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 7. Section 1.737–1 is amended by revising paragraph (c)(1) and adding paragraphs (c)(3) and (4) to read as follows:

§ 1.737–1 Recognition of precontribution gain.

* * * * *

(c) *Net precontribution gain*—(1) *General rule*. The distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) and § 1.704–4 if all property that had been contributed to the partnership by the distributee partner within seven years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than the partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership.

* * * * *

(3) *Determination of seven-year period*—(i) *General rule*. The seven-year period specified in paragraph (c)(1) of this section begins on, and includes, the date of contribution and ends on, and includes, the last date that is within seven years of the contribution. For example, if a partner contributes 704(c) property to a partnership on May 15, 2016, the seven-year period with respect to the section 704(c) property ends on, and includes, May 14, 2023.

(ii) *Section 708(b)(1)(B) terminations*. A termination of the partnership under section 708(b)(1)(B) does not begin a new seven-year period for each partner with respect to built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under § 1.708–1(b)(4). *See* § 1.704–3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property.

(4) *Effective/applicability date*. The provisions of paragraph (c)(1) and (3) of this section relating to the seven-year period for determining the applicability of section 737(b) apply for partnership contributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

Par. 8. Section 1.743–1 is amended by:

1. Revising the section heading.
2. Revising paragraph (a).
3. Revising paragraph (b).

4. Redesignating paragraph (f) introductory text as paragraph (f)(1) introductory text and revising it.
5. Adding paragraph (f)(2).
6. In paragraph (h)(1), removing "§ 1.708–1(b)(1)(iv)" and adding in its place "§ 1.708–1(b)(4)".
7. Revising paragraph (j)(3)(ii) *Example 1*.
8. Revising paragraph (j)(3)(ii) *Example 3*.
9. Revising paragraph (k)(1)(iii).
10. Adding paragraph (k)(2)(iv).
11. Redesignating paragraph (l) as paragraph (p).
12. Adding a new paragraph (l).
13. Adding paragraphs (m), (n), and (o).
14. Revising newly redesignated paragraph (p).

The revisions and additions read as follows:

§ 1.743–1 Special rules where partnership has a section 754 election in effect or has a substantial built-in loss immediately after transfer of partnership interest.

(a) *Generally*—(1) *Adjustment to basis*. The basis of partnership property is adjusted as a result of the transfer of an interest in a partnership by sale or exchange or on the death of a partner if the election provided by section 754 (relating to optional adjustments to the basis of partnership property) is in effect with respect to the partnership, or if the partnership has a substantial built-in loss (within the meaning of paragraph (a)(2)(i) of this section) immediately after the transfer.

(2) *Substantial built-in loss*—(i) *In general*. A partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in partnership property exceeds the fair market value of the property (as determined in paragraph (a)(2)(iii) of this section) by more than $250,000 immediately after the transfer.

(ii) *Impact of section 743 basis adjustments and section 704(c)(1)(C) basis adjustments*. For purposes of paragraph (a)(2)(i) of this section, any section 743 or section 704(c)(1)(C) basis adjustments (as defined in § 1.704–3(f)(2)(iii)) (other than the transferee's section 743(b) basis adjustments or section 704(c)(1)(C) basis adjustments) to partnership property are disregarded.

(iii) *Determination of fair market value in tiered situation*. For purposes of paragraph (a)(2)(i) of this section, an upper-tier partnership's fair market value in a lower-tier partnership is equal to the sum of—

(A) The amount of cash that the upper-tier partnership would receive if the lower-tier partnership sold all of its property for cash to an unrelated person for an amount equal to the fair market value of such property, satisfied all of its liabilities (other than § 1.752–7 liabilities), paid an unrelated person to assume all of its § 1.752–7 liabilities in a fully taxable, arm's-length transaction, and liquidated; and

(B) The upper-tier partnership's share of the lower-tier partnership's liabilities as determined under section 752 and the regulations.

(iv) *Example*. A and B are equal partners in PRS, a partnership. PRS owns Property 1, with an adjusted basis of $3 million and a fair market value of $2 million, and Property 2, with an adjusted basis of $1 million and a fair market value of $1 million. In Year 2, A sells 50 percent of its interest in PRS to C for its fair market value of $750,000. PRS does not have section 754 election in effect. Under paragraph (a)(2)(i) of this section, PRS has a substantial built-in loss because, immediately after the transfer, the adjusted basis of PRS's property ($4 million) exceeds the fair market value of the property ($3 million) by more than $250,000. Thus, pursuant to paragraph (a)(1) of this section, PRS must adjust the bases of its properties as if PRS had made a section 754 election for Year 2.

(b) *Determination of adjustment*. In the case of the transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership that has an election under section 754 in effect or that has a substantial built-in loss (within the meaning of paragraph (a)(2)(i) of this section) —

* * * * *

(f) *Subsequent transfers*—(1) *In general*. Where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. In the case of a gift of an interest in a partnership, the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to the gifted partnership interest. The following example illustrates the provisions of this paragraph (f)(1):

* * * * *

(2) *Special rules for substituted basis transactions*. Where a partner had a basis adjustment under section 743(b) allocated pursuant to § 1.755–1(b)(2) through (b)(4) that is attributable to an interest that is subsequently transferred in a substituted basis transaction (within the meaning of § 1.755–1(b)(5)), the provisions of paragraph (f)(1) of this section do not apply. Instead, the transferee succeeds to that portion of the transferor's basis adjustment attributable to the transferred partnership interest. The basis adjustment to which the transferee succeeds is taken into account for purposes of determining the transferee's share of the adjusted basis to the partnership of the partnership's property for purposes of paragraph (b) of this section and § 1.755–1(b)(5). To the extent a transferee would be required to decrease the adjusted basis of an item of partnership property pursuant to §§ 1.743–1(b)(2) and 1.755–1(b)(5), the decrease first reduces the positive section 743(b) adjustment, if any, that the transferee succeeds to. The following example illustrates the provisions of this paragraph (f)(2):

Example—(i) A and B are partners in LTP, a partnership. A owns a 60 percent interest, and B owns a 40 percent interest, in LTP. B owns the LTP interest with an adjusted basis of $50 and a fair market value of $70. LTP owns two assets: Capital Asset 1 with an adjusted basis of $25 and a fair market value of $100, and Capital Asset 2 with an adjusted basis of $100 and a fair market value of $75. B sells its interest in LTP to UTP. Both LTP and UTP have a section 754 election in effect. Pursuant to § 1.755–1(b)(3), UTP's $20 section 743(b) adjustment is allocated $30 to Capital Asset 1 and ($10) to Capital Asset 2.

(ii) UTP distributes its LTP interest to C, a partner in UTP, when the adjusted bases and fair market values of the LTP interest and LTP's assets have not changed. C's adjusted basis in its UTP interest at the time of the distribution is $40. Pursuant to paragraph (f)(2) of this section, C succeeds to UTP's section 743(b) adjustment. Also pursuant to paragraph (f)(2) of this section, the section 743(b) adjustment is taken into account in determining C's share of the adjusted basis of LTP property. Thus, C also has a $30 negative section 743(b) adjustment that must be allocated pursuant to § 1.755–1(b)(5). That is, C's interest in the partnership's previously taxed capital is $70 (C would be entitled to $70 cash on liquidation and there is no increase or decrease for tax gain or tax loss from the hypothetical transaction, taking into account UTP's section 743(b) adjustment to which C succeeds). Pursuant to § 1.755–1(b)(5)(iii)(B), the $30 negative section 743(b) adjustment must be allocated within the capital class first to properties with unrealized depreciation in proportion to C's share of the respective amounts of unrealized depreciation before the decrease. Taking into account UTP's section 743(b) adjustment to which C succeeds, C has no share of LTP's unrealized depreciation. Pursuant to § 1.755–1(b)(5)(iii)(B), any remaining decrease must be allocated among Capital Asset 1 and Capital Asset 2 in proportion to C's share of their adjusted bases. Taking into account UTP's section 743(b) adjustment to which C succeeds, C's share of the adjusted basis in Capital Asset 1 is $40 ($10 share of LTP's basis and $30 of UTP's section 743(b) adjustment to which C succeeded) and in Capital Asset 2 is $30 ($40 share of LTP's basis and ($10) of UTP's section 743(b) adjustment). Thus, 40/70 of the $30 adjustment, $17.14, is allocated to Capital Asset 1 and 30/70 of the $30 adjustment, $12.86, is allocated to Capital Asset 2. The decrease allocated to Capital Asset 1 first reduces UTP's section 743(b) adjustment to which C succeeds. Thus, C has a net section 743(b) adjustment in Capital Asset 1 of $12.86 ($30 minus $17.14) and in Capital Asset 2 of ($22.86) (($10) plus ($12.86)). If Capital Asset 1 is subject to the allowance for depreciation or amortization, C's net $12.86 positive basis adjustment is recovered pursuant to paragraph (j)(4)(i)(B).

(iii) If C later transfers its LTP interest to D in a transaction that is not a substituted basis transaction within the meaning of § 1.755–1(b)(5), under paragraph (f)(1) of this section, D does not succeed to any of C's section 743(b) adjustment.

* * * * *

(j) * * *

(3) * * *

(ii) * * *

Example 1. A and B form equal partnership PRS. A and B each contribute $100 cash, and PRS purchases nondepreciable property for $200. Later, at a time when the property value has decreased to $100, C contributes $50 cash for a 1/3 interest in PRS. Under § 1.704–1(b)(2)(iv)(*f*)(*5*), PRS revalues its property in connection with the admission of C, allocating the $100 unrealized loss in the property equally between A and B under the partnership agreement, which provides for the use of the traditional method under § 1.704–3(b). A subsequently sells its interest in PRS to T for $50. PRS has an election in effect under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS later sells the property for $120. PRS recognizes a book gain of $20 (allocated equally between T, B, and C), and a tax loss of $80. T will receive an allocation of $40 of tax loss under the principles of section 704(c). However, because T has a negative $50 basis adjustment in the nondepreciable property, T recognizes a $10 gain from the partnership's sale of the property.

* * * * *

Example 3. A and B form equal partnership PRS. A and B each contribute $75 cash. PRS purchases nondepreciable property for $150. Later, at a time when the property value has decreased to $100, C contributes $50 cash for a 1/3 interest in PRS. Under § 1.704–1(b)(2)(iv)(*f*)(*5*), PRS revalues its property in connection with the admission of C. The $50 unrealized loss in the property is allocated equally to A and B under the partnership agreement, which provides for the use of the remedial allocation method described in § 1.704–3(d). A subsequently sells its interest in PRS to T for $50. PRS has an election in effect under section 754. T receives a negative $25 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS later sells the property for $112. PRS recognizes a book gain of $12 (allocated equally between T, B, and C), and a tax loss of $38 (allocated equally between T and B). To match its share of book gain, C will be allocated $4 of remedial gain, and T and B will each be allocated an offsetting $2 remedial loss. T was allocated a total of $21 of tax loss with respect to the property. However, because T has a negative $25 basis adjustment in the nondepreciable property, T recognizes a $4 gain from the partnership's sale of the property.

* * * * *

(k) * * *

(1) * * *

(iii) *Rules for substantial built-in loss transactions*. A partnership required to adjust the basis of partnership property following the transfer of an interest in a partnership by sale or exchange or on the death of a partner as the result of the partnership having a substantial built-in loss (as defined in paragraph (a)(2)(i) of this section) immediately after such transfer is subject to, and required to comply with, this paragraph (k)(1), and may rely on, and must comply with, paragraphs (k)(3), (k)(4), and (k)(5) of this section solely with respect to the transfer to which the substantial built-in loss relates as if an election under section 754 were in effect at the time of the transfer. *See* paragraph (k)(2) of this section for additional rules for transferees and paragraph (n) of this section for special reporting rules relating to electing investment partnerships.

(2) * * *

(iv) *Special rules for transferees subject to the substantial built-in loss provisions*. The transferee of an interest in a partnership that is required to reduce the bases of partnership property in accordance with the rules in paragraph (a)(2) of this section must comply with this paragraph (k)(2) as if an election under section 754 were in effect at the time of the transfer.

(l) *Basis adjustments with respect to tiered partnerships*—(1) *General rule*. If an interest in an upper-tier partnership that holds an interest in a lower-tier partnership is transferred by sale or exchange or upon the death of a partner, and the upper-tier partnership and the lower-tier partnership both have elections in effect under section 754, then for purposes of section 743(b) and section 754, an interest in the lower-tier partnership will be deemed similarly transferred in an amount equal to the portion of the upper-tier partnership's interest in the lower-tier partnership that is attributable to the interest in the upper-tier partnership being transferred. Additionally, if an interest in an upper-tier partnership that holds (directly or indirectly through one or more partnerships) an interest in a lower-tier partnership is transferred by sale or exchange or on the death of a partner, and the upper-tier partnership has a substantial built-in loss (within the meaning of paragraph (a)(2)(i) of this section) with respect to the transfer, each lower-tier partnership is treated, solely with respect to the transfer, as if it had made a section 754 election for the taxable year of the transfer. For additional examples of the application of the principles of this paragraph (l), see Revenue Ruling 87–115, 1987–2 CB 163. *See* § 601.601(d)(2)(ii)(b).

(2) *Example*. The following example illustrates the principles of this paragraph (l).

Example. A and B are equal partners in UTP, a partnership. UTP has no liabilities and owns a 25 percent interest in LTP, a partnership. UTP's interest in LTP has a fair market value of $100,000 and an adjusted basis of $500,000. LTP has no liabilities and owns Land, which has a fair market value of $400,000 and an adjusted basis of $2 million. In Year 3, when UTP and LTP do not have section 754 elections in effect, B sells 50 percent of its interest in UTP to C for its fair market value of $25,000. Because the adjusted basis of UTP's interest in LTP ($500,000) exceeds the fair market value of UTP's interest in LTP ($100,000) by more than $250,000 immediately after the transfer, UTP has a substantial built-in loss with respect to the transfer. Thus, pursuant to paragraph (l) of this section, UTP must adjust the basis of its interest in LTP, and LTP must adjust the basis of Land, as if it had made a section 754 election for Year 3.

(m) *Anti-abuse rule for substantial built-in loss transactions*. Provisions relating to substantial built-in loss transactions in paragraph (a) and paragraphs (k), (l), (n), and (o) of this section must be applied in a manner consistent with the purposes of these paragraphs and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of one or more of these paragraphs, the Commissioner may recast the transaction for Federal income tax purposes, as appropriate, to achieve tax results that are consistent with the purpose of these paragraphs. Whether a tax result is inconsistent with the purposes of the provisions is determined based on all the facts and circumstances. For example, under the provisions of this paragraph (m)—

(1) Property held by related partnerships may be aggregated if the properties were transferred to the related partnerships with a principal purpose of avoiding the application of the substantial built-in loss provisions in section 743 and the regulations; and

(2) A contribution of property to a partnership may be disregarded if the transfer of the property was made with a principal purpose of avoiding the application of the substantial built-in loss provisions in section 743 and the regulations thereunder.

(n) *Electing investment partnerships*—(1) *No adjustment of partnership basis*. For purposes of this section, an electing investment partnership (as defined in paragraph (n)(6) of this section) shall not be treated as having a substantial built-in loss (within the meaning of paragraph (a)(2)(i) of this section) with respect to any transfer occurring while the election in paragraph (n)(6)(i) of this section is in effect.

(2) *Loss deferral for transferee partner*. In the case of a transfer of an interest in an electing investment partnership, the transferee partner's distributive share of losses (without regard to gains) from the sale or exchange of partnership property shall not be allowed except to the extent that it is established that such losses exceed the loss (if any) recognized by the transferor partner (or by any prior transferor to the extent not fully offset by a prior disallowance under this paragraph (n)(2)) on the transfer of the partnership interest. If an electing investment partnership allocates losses with a different character from the sale or exchange of property to the transferee (such as ordinary or section 1231 losses and capital losses) and the losses allocated to that partner are limited by this paragraph (n)(2), then a proportionate amount of the losses disallowed under this paragraph (n)(2) shall consist of each loss of a separate character that is allocated to the transferee partner.

(3) *No reduction in partnership basis*. Losses disallowed under paragraph (n)(2) of this section shall not decrease the transferee partner's basis in the partnership interest.

(4) *Effect of termination of partnership*. This paragraph (n) shall be applied without regard to any termination of a partnership under section 708(b)(1)(B).

(5) *Certain basis reductions treated as losses*. In the case of a transferee partner whose basis in property distributed by the partnership is reduced under section 732(a)(2), the amount of the loss recognized by the transferor on the transfer of the partnership interest that is taken into account under paragraph (n)(2) of this section shall be reduced by the amount of such basis reduction.

(6) *Electing investment partnership*. For purposes of this section, the term *electing investment partnership* means any partnership if—

(i) The partnership makes an election under paragraph (n)(10) of this section to have this paragraph (n) apply;

(ii) The partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of section 3(c) of such Act;

(iii) The partnership has never been engaged in a trade or business (see paragraph (n)(7) of this section for additional rules regarding this paragraph (n)(6)(iii));

(iv) Substantially all of the assets of the partnership are held for investment;

(v) At least 95 percent of the assets contributed to the partnership consist of money;

(vi) No assets contributed to the partnership had an adjusted basis in excess of fair market value at the time of contribution;

(vii) All partnership interests of the partnership are issued by the partnership pursuant to a private offering before the date that is 24 months after the date of the first capital contribution to the partnership;

(viii) The partnership agreement of the partnership has substantive restrictions on each partner's ability to cause a redemption of the partner's interest (see paragraphs (n)(8) and (n)(9) of this section for additional rules regarding this paragraph (n)(6)(viii)); and

(ix) The partnership agreement of the partnership provides for a term that is not in excess of 15 years (see paragraph (n)(9) of this section for additional rules regarding this paragraph (n)(6)(ix)).

(7) *Trade or business*. For purposes of paragraph (n)(6)(iii) of this section, whether a partnership is engaged in a trade or business is based on the all the facts and circumstances. Notwithstanding the prior sentence—

(i) A partnership will not be treated as engaged in a trade or business if, based on all the facts and circumstances, the partnership is not engaged in a trade or business under the rules in § 1.731–2(e)(3).

(ii) In the case of a tiered partnership arrangement, a partnership (upper-tier partnership) will not be treated as engaged in a trade or business of a partnership in which it owns an interest (lower-tier partnership) if the upper-tier partnership can establish that, at all times during the period in which the upper-tier partnership owns an interest in the lower-tier partnership, the adjusted basis of its interest in the lower-tier partnership is less than 25 percent of the total capital that is required to be contributed to the upper-tier partnership by its partners during the entire term of the upper-tier partnership. Otherwise, the upper-tier partnership will be treated as engaged in the trade or business of the lower-tier partnership.

(8) *Substantive restrictions*. For purposes of paragraph (n)(6)(viii) of this section, substantive restrictions include cases in which a redemption is permitted under a partnership agreement only if the redemption is necessary to avoid a violation of state, federal, or local laws (such as ERISA or the Bank Holding Company Act) or the imposition of a federal excise tax on, or a change in the federal tax-exempt status of, a tax-exempt partner.

(9) *Special rules for partnerships in existence on June 4, 2004*. In the case of a partnership in existence on June 4, 2004, paragraph (n)(6)(viii) of this section will not apply to the partnership and paragraph (n)(6)(ix) of this section is applied by substituting "20 years" for "15 years."

(10) *Election*—(i) *Eligibility*. A partnership is eligible to make the election described in paragraph (n)(6)(i) of this section if the partnership meets the definition of an electing investment partnership in paragraph (n)(6) of this section and does not have an election under section 754 in effect.

(ii) *Manner of making election*. A partnership must make the election by attaching a written statement to an original return for the taxable year for which the election is effective. The original return must be filed not later than the time prescribed by § 1.6031(a)–1(e) of the Procedure and Administration Regulations (including extensions) for filing the return for the taxable year for which the election is effective. If the partnership is not otherwise required to file a partnership return, the election shall be made in accordance with the rules in § 1.6031(a)–1(b)(5) of the Procedure and Administration Regulations. The statement must—

(A) Set forth the name, address, and tax identification number of the partnership making the election;

(B) Contain a representation that the partnership is eligible to make the election; and

(C) Contain a declaration that the partnership elects to be treated as an electing investment partnership.

(iii) *Effect and duration of election*. Once the election is made, the election is effective for all transfers during the partnership's taxable year for which the election is effective and all succeeding taxable years, except as provided in paragraphs (n)(10)(iv) and (n)(10)(v) of this section.

(iv) *Termination of election*—(A) *In general*. The election terminates if the partnership fails to meet the definition of an electing investment partnership. The electing investment partnership's election also terminates if the partnership files an election under section 754.

(B) *Effect of termination*. If the election terminates, the partnership will be subject to the substantial built-in loss provisions in this section with respect to the first transfer of a partnership interest that occurs after the partnership ceases to meet the definition of an electing investment partnership (or the first transfer that occurs after the effective date of the section 754 election) and to each subsequent transfer. In addition, any losses that are subsequently allocated to a partner to whom a partnership interest was transferred while the election was in effect shall remain subject to the rules in paragraph (n)(2) of this section.

(v) *Revocation of election*—(A) *In general*. The election, once made, shall be irrevocable except with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request.

(B) *Effect of revocation*. If the election is properly revoked, the partnership will be subject to the substantial built-in loss provisions in this section with respect to the first transfer of a partnership interest that occurs after the effective date of the revocation and to each subsequent transfer. In addition, any losses that are subsequently allocated to a partner to whom a partnership interest was transferred while the election was in effect shall remain subject to the rules in paragraph (n)(2) of this section.

(11) *Transferor partner required to provide information to transferee partner and partnership*—(i) *In general*. Except as provided in paragraph (n)(11)(ii) of this section, if an electing investment partnership interest is transferred in a sale or exchange or upon the death of a partner, the transferor (or, in the case of a partner who dies, the partner's executor, personal representative, or other successor in interest) must notify the transferee and the partnership in writing. If the transferor is a nominee (within the meaning of § 1.6031(c)–1T), then the nominee, and not the beneficial owner of the transferred interest, must supply the information to the transferee and the partnership. The notice must be provided within 30 days after the date on which the transferor partner (or the executor, personal representative, or other successor in interest) receives a Schedule K-1 from the partnership for the partnership's taxable year in which the transfer occurred. The notice must be signed under penalties of perjury, must be retained by the transferee and the partnership as long as the contents thereof may be material in the administration of any internal revenue law, and must include—

(A) The name, address, and tax identification number of the transferor;

(B) The name, address, and tax identification number of the transferee (if ascertainable);

(C) The name of the electing investment partnership;

(D) The date of the transfer (and, in the case of the death of a partner, the date of the death of the partner);

(E) The amount of loss, if any, recognized by the transferor on the transfer of the interest, together with the computation of the loss;

(F) The amount of losses, if any, recognized by any prior transferors to the extent the losses were subject to disallowance under paragraph (n)(2) of this section in the hands of a prior transferee and have not been offset by prior loss disallowances under paragraph (n)(2) of this section; and

(G) Any other information necessary for the transferee to compute the amount of loss disallowed under paragraph (n)(2) of this section.

(ii) *Exception*. The rules of paragraph (n)(11)(i) of this section do not apply if the transferor recognizes a gain on the transfer and no prior transferor recognized a loss on any transfer.

(iii) *Effect of failure to notify transferee partner*. If the transferor partner, its legal representative in the case of a transfer by death, or the nominee (if the transferor is a nominee) fails to provide the transferee partner with the statement, the transferee partner must treat all losses allocated from the electing investment partnership as disallowed under paragraph (n)(2) of this section unless the transferee partner obtains, from the partnership or otherwise, the information necessary to determine the proper amount of losses disallowed under paragraph (n)(2) of this section. If the transferee does not have the information necessary to determine the proper amount of losses disallowed under paragraph (n)(2) of this section, but does have information sufficient to determine the maximum amount of losses that could be disallowed, then the transferee may treat the amount of losses disallowed under paragraph (n)(2) of this section as being equal to that maximum amount. For example, if the transferee is able to ascertain the adjusted basis that a prior transferor had in its partnership interest, but is not able to ascertain the amount realized by that transferor, the transferee may assume, for purposes of calculating the amount of losses disallowed under paragraph (n)(2) of this section, that the sales price when the prior transferor sold its interest was zero. If, following the filing of a return pursuant to the previous sentence, the transferor partner or the partnership provides the required information to the transferee partner, the transferee partner should make appropriate adjustments in an amended return for the year of the loss allocation from the partnership in accordance with section 6511 or other applicable rules.

(iv) *Additional rules*. See paragraph (n)(12)(i) of this section for additional reporting requirements when the electing investment partnership is not required to file a partnership return.

(12) *Electing investment partnership required to provide information to partners*—(i) *Distributive shares of partnership items*. An electing investment partnership is required to separately state on Schedule K and K-1 of the partnership's return (Form 1065) all allocations of losses to all of its partners under § 1.702–1(a)(8)(ii), including losses that, in the absence of section 743(e), could be netted against gains at the partnership level. If a partnership's election to be treated as an electing investment partnership is terminated or revoked under paragraphs (n)(10)(iv) or (n)(10)(v) of this section, the partnership must continue to state such gains and losses separately in future returns relating to any period during which the partnership has one or more transferee partners that are subject to section paragraph (n)(2) of this section. If an electing investment partnership is not required to file a partnership return, the transferee of a partnership interest may be required to provide the Commissioner similar information regarding the partner's distributive share of gross gains and losses of the partnership under § 1.6031(a)–1(b)(4).

(ii) *Annual statement*. An electing investment partnership must provide an annual statement to all of its partners. The statement must be attached to every statement provided to a partner or nominee under section 6031(b) that is issued with respect to any taxable year for which an election to be treated as an electing investment partnership is in effect (whether or not the election is in effect for the entire taxable year). The statement must include the following—

(A) A statement that the partnership has elected to be treated as an electing investment partnership;

(B) A statement that, unless the transferor partner recognizes a gain on the transfer and no prior transferor recognized a loss on any transfer, if a partner transfers an interest in the partnership to another person, the transferor partner must, within 30 days after receiving a Schedule K-1 from the partnership for the taxable year that includes the date of the transfer, provide the transferee with certain information, including the amount, if any, of loss that the transferor recognized on the transfer of the partnership interest, and the amount of losses, if any, recognized by prior transferors with respect to the same interest; and

(C) A statement that if an interest in the partnership is transferred to a transferee partner, the transferee is required to reduce its distributive share of losses from the partnership, determined without regard to gains from the partnership, to the extent of any losses recognized by the transferor partner when that partner transferred the partnership interest to the transferee (and to the extent of other losses recognized on prior transfers of the same partnership interest that have not been offset by prior loss disallowances). The statement must also notify the transferee that it is required to reduce its share of losses as reported to the transferee by the partnership each year by the amount of any loss recognized by the transferor partner (or any prior transferor to the extent not already offset by prior loss disallowances) until the transferee has reduced its share of partnership losses by the total amount of losses required to be disallowed. Finally, the statement must state that if the transferor partner (or its nominee), or its legal representative in the case of a transfer by death, fails to provide the transferee with the required statement, the transferee must treat all losses allocated from the partnership as disallowed unless the transferee obtains, from the partnership or otherwise, the information necessary to determine the proper amount of losses disallowed.

(o) *Securitization partnerships*—(1) *General rule*. A securitization partnership (as defined in paragraph (o)(2) of this section) shall not be treated as having a substantial built-in loss with respect to any transfer.

(2) *Definition of securitization partnership*. A *securitization partnership* means any partnership the sole business activity of which is to issue securities that provide for a fixed principal (or similar) amount and that are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets that by their terms convert into cash in a finite period, but only if the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired for the purpose of being disposed of.

(p) *Effective/applicability date*. * * * Paragraph (f)(2) of this section and the provisions relating to substantial built-in losses in paragraph (a) and paragraphs (k), (l), (m), (n), and (o) of this section are effective for transfers of partnership interests occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 9. Section 1.755–1 is amended by:

1. Revising paragraph (b)(5).
2. Redesignating paragraph (e) as paragraph (f).
3. Adding a new paragraph (e).
4. Revising newly redesignated paragraph (f).

The revisions and addition read as follows:

§ 1.755–1 Rules for allocation of basis.

* * * * *

(b) * * *

* * * * *

(5) *Substituted basis transactions*—(i) *In general*. This paragraph (b)(5) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest and from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. For example, this paragraph (b)(5) applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies, if a partnership interest is contributed to a partnership in a transaction to which section 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which section 731(a) applies.

(ii) *Allocations between classes of property*–(A) *No adjustment*. If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5).

(B) *Increases*. If there is an increase in basis to be allocated to partnership assets, the increase must be allocated between capital gain property and ordinary income property in proportion to, and to the extent of, the gross gain or gross income (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining increase must be allocated between the classes in proportion to the fair market value of all property in each class.

(C) *Decreases*. If there is a decrease in basis to be allocated to partnership assets, the decrease must be allocated between capital gain property and ordinary income property in proportion to, and to the extent of, the gross loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining decrease must be allocated between the classes in proportion to the transferee's shares of the adjusted bases of all property in each class (as adjusted under the preceding sentence).

(iii) *Allocations within the classes*—(A) *Increases*. If, under paragraph (b)(5)(ii) of this section, there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation (to the extent attributable to the acquired partnership interest) before the increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

(B) *Decreases*. If, under paragraph (b)(5)(ii) of this section, there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation (to the extent attributable to the acquired partnership interest) before the decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

(C) *Limitation in decrease of basis*. Where, as a result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all assets in that class, the basis of the property is reduced to zero (but not below zero).

(D) *Carryover adjustment*. Where a transferee's negative basis adjustment under section 743(b) cannot be allocated to any asset, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(iv) *Examples*. The provisions of this paragraph (b)(5) are illustrated by the following examples—

Example 1. * * *

Example 2. * * *

Example 3—(i) A is a one-third partner in UTP, a partnership, which has a valid election in effect under section 754. The three partners in UTP have equal interests in the capital and profits of UTP. UTP has three assets with the following adjusted bases and fair market values:

Assets	Adjusted basis	Fair market value
Intangible 1	$30	$200
Land	$200	$200
50% interest in LTP	$190	$200

LTP, a partnership, has a section 754 election in effect for the year of the distribution. LTP owns three assets with the following adjusted bases and fair market values:

Assets	Adjusted basis	Fair market value
Intangible 2	$340	$100
Intangible 3	$20	$280
Inventory	$20	$20

UTP distributes its interest in LTP in redemption of A's interest in UTP. At the time of the distribution, A's adjusted basis in its UTP interest is $140. A recognizes no gain or loss on the distribution. Under section 732(b), A's basis in the distributed LTP interest is $140. Under sections 734(b) and 755, UTP increases its adjusted basis in Intangible 1 by $50, the amount of the basis adjustment to the LTP interest in the hands of A.

(ii) The amount of the basis adjustment with respect to LTP under section 743(b) is the difference between A's basis in LTP of $140 and A's share of the adjusted basis to LTP of partnership property. A's share of the adjusted basis to LTP of partnership property is equal to the sum of A's share of LTP's liabilities of $0 plus A's interest in the previously taxed capital of LTP of $190 ($200, A's cash on liquidation, increased by $120, the amount of tax loss allocated to A from the sale of Intangible 2 in the hypothetical transaction, decreased by $130, the amount of tax gain allocated to A from the sale of Intangible 3 in the hypothetical transaction). Therefore, the amount of the negative basis adjustment under section 743(b) to partnership property is $50.

(iii) Under this paragraph (b)(5), LTP must allocate $50 of A's negative basis adjustment between capital gain property and ordinary income property in proportion to, and to the extent of, the gross loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to A from the hypothetical sale of all property in each class. If LTP disposed of its assets in a hypothetical sale, A would be allocated $120 of gross loss from Intangible 2 only. Accordingly, the $50 negative adjustment must be allocated to capital assets. Under paragraph (b)(5)(iii)(B) of this section, the $50 negative adjustment must be allocated to the assets in the capital class first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation. Thus, the $50 negative adjustment must be allocated entirely to Intangible 2.

Example 4—(i) A is a one-third partner in LTP. The three partners in LTP have equal interests in the capital and profits of LTP. LTP has two assets: accounts receivable with an adjusted basis of $300 and a fair market value of $240 and a nondepreciable capital asset with an adjusted basis of $60 and a fair market value of $240. A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its LTP interest is $90. Under section 723, UTP's basis in its LTP interest is $90. LTP makes an election under section 754 in connection with the transfer.

(ii) The amount of the basis adjustment under section 743(b) is the difference between UTP's $90 basis in its LTP interest and UTP's share of the adjusted basis to LTP of LTP's property. UTP's share of the adjusted basis to LTP of LTP's property is equal to the sum of UTP's share of LTP's liabilities of $0 plus UTP's interest in the previously taxed capital of LTP of $120 ($160, the amount of cash on liquidation, increased by $20, the amount of tax loss allocated to UTP from the hypothetical transaction, and decreased by $60, the amount of tax gain allocated to UTP from the hypothetical transaction). Therefore, the amount of the negative basis adjustment under section 743(b) to partnership property is $30.

(iii) The total amount of gross loss that would be allocated to UTP from the hypothetical sale of LTP's ordinary income property is $20 (one third of the excess of the basis of the accounts receivable ($300) over their fair market value ($240)). The hypothetical sale of LTP's capital gain property would result in a net gain. Therefore, under this paragraph (b)(5), $20 of the $30 basis adjustment must be allocated to ordinary income property. Because LTP holds only one ordinary income property, the $20 decrease must be allocated entirely to the accounts receivable. Pursuant to paragraph (b)(5)(ii)(C) of this section, the remaining $10 basis adjustment must be allocated between ordinary income property and capital gain property according to UTP's share of the adjusted bases of such properties. Therefore, $8 ($10 multiplied by $80 divided by $100) would be allocated to the accounts receivable and $2 ($10 multiplied by $20 divided by $100) would be allocated to the nondepreciable capital asset. * * *

* * * * *

(e) *No allocation of basis decrease to stock of corporate partner*—(1) *In general*. In making an allocation under section 755(a) of any decrease in the adjusted basis of partnership property under section 734(b)—

(A) No allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) or 707(b)(1)) to such corporation) that is a partner in the partnership; and

(B) Any amount not allocable to stock by reason of paragraph (c)(1) of this section shall be allocated under section 755(a) to other partnership property.

(2) *Recognition of gain*. Gain shall be recognized to the partnership to the extent that the amount required to be allocated under paragraph (e)(1)(B) of this section to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the allocation required by paragraph (e)(1)(B) of this section.

(3) *Example*. A, B, and C are equal partners in PRS, a partnership. C is a corporation. The adjusted basis and fair market value for A's interest in PRS is $100. PRS owns Capital Asset 1 with an adjusted basis of $0 and a fair market value of $100, Capital Asset 2 with an adjusted basis of $150 and a fair market value of $50, and stock in Corp, a corporation that is related to C under section 267(b), with an adjusted basis of $250 and fair market value of $150. PRS has a section 754 election in effect. PRS distributes Capital Asset 1 to A in liquidation of A's interest in PRS. PRS will reduce the basis of its remaining assets under section 734(b) by $100, to be allocated under section 755. Pursuant to the general rule of paragraph (c) of this section, PRS would reduce the basis of Capital Asset 2 by $50 and the stock of Corp by $50. However, pursuant to paragraph (e)(1)(A) of this section, the basis of the Corp stock is not adjusted. Thus, the basis of Capital Asset 2 is reduced by $100 from $150 to $50.

(f) *Effective date*—(1) *Generally*. Except as provided in paragraph (f)(2) of this section, this section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

(2) *Special rules*. Paragraphs (a) and (b)(3)(iii) of this section apply to transfers of partnership interests and distributions of property from a partnership that occur on or after June 9, 2003. Paragraph (b)(5) of this section applies to transfers of partnership interests occurring on or after January 16, 2014**.** Paragraph (e) of this section applies to transfers of partnership interests occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

§ 1.1502–13 [Amended]

Par. 10. Section 1.1502–13 is amended by:

1. Amending paragraph (h)(2), *Example 4*, by removing "Five years" and adding in its place "Seven years".

Beth Tucker
Deputy Commissioner for Operations Support.

(Filed by the Office of the Federal Register on January 15, 2014, 8:45 a.m., and published in the issue of the Federal Register for January 16, 2014, 79, F.R. 3042)

Notice of Proposed Rulemaking Basis in Interests in Tax-Exempt Trusts

REG–154890–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide rules for determining a taxable beneficiary's basis in a term interest in a charitable remainder trust upon a sale or other disposition of all interests in the trust to the extent that basis consists of a share of adjusted uniform basis. The regulations affect taxable beneficiaries of charitable remainder trusts.

DATES: Written or electronic comments and requests for a public hearing must be received by April 17, 2014.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–154890–03), room 5205, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–154890–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–154890–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Allison R. Carmody at (202) 317-5279; concerning submissions of comments and requests for hearing, Oluwafunmilayo (Funmi) Taylor, at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Statutory and Regulatory Rules

Charitable Remainder Trusts

A charitable remainder trust (CRT) is a trust that provides for the distribution of an annuity or a unitrust amount, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a limited term of years, with an irrevocable remainder interest held for the benefit of, or paid over to, charity. Thus, there is at least one current income beneficiary of a CRT, and a charitable remainder beneficiary. A CRT is not subject to income tax. See section 664(c).

Uniform Basis Rule

Property acquired by a trust from a decedent or as a gift generally has a uniform basis. This means that property has a single basis even though more than one person has an interest in that property. See

§§ 1.1014–4(a)(1) and 1.1015–1(b). Generally, the uniform basis of assets transferred to a trust is determined under section 1015 for assets transferred by lifetime gift, or under section 1014 or 1022 for assets transferred from a decedent. Adjustments to uniform basis for items such as depreciation are made even though more than one person holds an interest in the property (adjusted uniform basis).

When a taxable trust sells assets, any gain is taxed currently to the trust, to one or more beneficiaries, or apportioned among the trust and its beneficiaries. If the trust reinvests the proceeds from the sale in new assets, the trust's basis in the newly purchased assets is the cost of the new assets. See section 1012. Thus, the adjusted uniform basis of that taxable trust is attributable to basis obtained with proceeds from sales that were subject to income tax.

However, a CRT does not pay income tax on gain from the sale of appreciated assets. A CRT may sell appreciated assets and accumulate undistributed income and undistributed capital gains, and may reinvest the proceeds of the sales in new assets. The treatment of distributions from a CRT to its income beneficiary depends upon the amount of undistributed income and undistributed capital gains in the CRT. Sections 664(b)(1) and (2).

Basis in Term and Remainder Interests in a CRT

Section 1001(e) governs the determination of gain or loss from the sale or disposition of a term interest in property, such as a life or term interest in a CRT. In general, section 1001(e)(1) provides that the portion of the adjusted basis of a term interest in property that is determined pursuant to sections 1014, 1015, or 1041 is disregarded in determining gain or loss from the sale or other disposition of such term interest. Thus, the seller of such an interest generally must disregard that portion of the basis in the transferred interest in computing the gain or loss.

Section 1001(e)(3), however, provides that section 1001(e)(1) does not apply to a sale or other disposition that is part of a transaction in which the entire interest in property is transferred. Therefore, in the case of a sale or other disposition that is part of a transaction in which all interests in the property (or trust) are transferred as described in section 1001(e)(3), the capital gain or loss of each seller of an interest is the excess of the amount realized from the sale of that interest over the seller's basis in that interest. Each seller's basis is the seller's portion of the adjusted uniform basis assignable to the interest so transferred. See § 1.1014–5(a)(1).

The basis of a term or remainder interest in a trust at the time of its sale or other disposition is determined under the rules provided in § 1.1014–5. See also §§ 1.1015–1(b) and 1.1015–2(a)(2), which refer to the rules of § 1.1014–5. Specifically, § 1.1014–5(a)(3) provides that, in determining the basis in a term or remainder interest in property at the time of the interest's sale or disposition, adjusted uniform basis is allocated using the factors for valuing life estates and remainder interests. Thus, the portions of the adjusted uniform basis attributable to the interests of the life tenant and remaindermen are adjusted to reflect the change in the relative values of such interests due to the lapse of time.

Notice 2008–99

The IRS and the Treasury Department became aware of a type of transaction involving these provisions and, on October 31, 2008, the IRS and the Treasury Department published Notice 2008–99 (2008–47 IRB 1194) ("Notice") to designate a transaction and substantially similar transactions as Transactions of Interest under § 1.6011–4(b)(6) of the Income Tax Regulations, and to ask for public comments on how the transactions might be addressed in published guidance. In this type of transaction, a sale or other disposition of all interests in a CRT subsequent to the contribution of appreciated assets to, and their reinvestment by, the CRT results in the grantor or other noncharitable beneficiary (the taxable beneficiary) receiving the value of the taxable beneficiary's trust interest while claiming to recognize little or no taxable gain.

Specifically, upon contribution of assets to the CRT, the grantor claims an income tax deduction under section 170 of the Internal Revenue Code (Code) for the portion of the fair market value of the assets contributed to the CRT (which generally have a fair market value in excess of the grantor's cost basis) that is attributable to the charitable remainder interest. When the CRT sells or liquidates the contributed assets, the taxable beneficiary does not recognize gain, and the CRT is exempt from tax on such gain under section 664(c). The CRT reinvests the proceeds in other assets, often a portfolio of marketable securities, with a basis equal to the portfolio's cost. The taxable beneficiary and charity subsequently sell all of their respective interests in the CRT to a third party.

The taxable beneficiary takes the position that the entire interest in the CRT has been sold as described in section 1001(e)(3) and, therefore, section 1001(e)(1) does not apply to the transaction. As a result, the taxable beneficiary computes gain on the sale of the taxable beneficiary's term interest by taking into account the portion of the uniform basis allocable to the term interest under §§ 1.1014–5 and 1.1015–1(b). The taxable beneficiary takes the position that this uniform basis is derived from the basis of the new assets acquired by the CRT rather than the grantor's basis in the assets contributed to the CRT.

Explanation of Provisions

In response to the request for comments in the Notice, the IRS and the Treasury Department received three written comments. All three commenters agreed that a taxable beneficiary of a CRT should not benefit from a basis step-up attributable to tax-exempt gains, and each supported amending the uniform basis rules to foreclose this benefit. The IRS and the Treasury Department agree that it is inappropriate for a taxable beneficiary to share in the uniform basis obtained through the reinvestment of income not subject to tax due to a trust's tax-exempt status.

Accordingly, these proposed regulations provide a special rule for determining the basis in certain CRT term interests in transactions to which section 1001(e)(3) applies. In these cases, the proposed regulations provide that the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1); and (2) the amount of undistributed net capital gain described in section 664(b)(2). These proposed regulations do not affect the CRT's basis in its assets, but rather are for the purpose of determining a taxable beneficiary's gain arising from a transaction described in section 1001(e)(3). However, the IRS and the Treasury Department may consider whether there should be any change in the treatment of the charitable remainderman participating in such a transaction.

In addition to the comments supportive of a basis limitation described above and proposed to be adopted herein, the commenters addressed additional issues in response to the Notice. One commenter requested guidance specifying what valuation methods the IRS will accept as a reasonable method for determining the amount of a life-income recipient's gain on the termination of certain types of CRTs. Another commenter suggested that the IRS and the Treasury Department could create a rule requiring a zero basis for all interests in CRTs in order to prevent an inappropriate result while still allowing for early termination of CRTs. The commenter also proposed that this rule be made applicable to all early terminations of CRTs. The IRS and the Treasury Department did not adopt a rule requiring a zero basis for all interests in CRTs because the IRS and the Treasury Department believe that the rule provided in the proposed regulations will prevent inappropriate results while treating parties to the transaction fairly. Additionally, the IRS and the Treasury Department believe that rules addressing early terminations other than those arising from a transaction described in section 1001(e)(3), and rules prescribing valuation methods, are beyond the scope of the issues intended to be addressed in these proposed regulations, and thus will not be considered as part of this guidance.

Finally, the rules in these proposed regulations are limited in application to charitable remainder annuity trusts and charitable remainder unitrusts as defined in section 664. The IRS and the Treasury Department request comments as to whether the rules also should apply to other types of tax-exempt trusts.

Effect on Other Documents

The issuance of these proposed regulations does not affect the disclosure obligation set forth in the Notice.

Proposed Effective/Applicability Date

These regulations are proposed to apply to sales and other dispositions of interests in CRTs occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014. However, the inapplicability of these regulations to an excepted sale or disposition does not preclude the IRS from applying legal arguments available to the IRS before issuance of these regulations in order to contest the claimed tax treatment of such a transaction.

Availability of IRS Documents

The IRS notice cited in this preamble is published in the Internal Revenue Bulletin or Cumulative Bulletin and is available at the IRS website at *http://www.irs.gov* or the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C., 20402.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It 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 the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations because the regulations do not impose a collection of information on small entities. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department also request comments on the administrability and clarity of the proposed rules, and how they can be made easier to understand. All comments will be available for public inspection and copying at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person who timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register.**

Drafting Information

The principal author of these proposed regulations is Allison R. Carmody of the Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

§ 1.1001–1 [Amended]

Par. 2. Section 1.1001–1, paragraph (f)(4), is amended by removing the language "paragraph (c)" and adding "paragraph (d)" in its place.

§ 1.1014–5 [Amended]

Par. 3. Section 1.1014–5 is amended by:

1. In paragraph (a)(1), first sentence, removing the language "paragraph (b)" and adding "paragraph (b) or (c)" in its place.

2. Re-designating paragraph (c) as newly-designated paragraph (d) and adding new paragraph (c).

3. In newly-designated paragraph (d), adding new *Example 7* and *Example 8*.

The additions read as follows:

§ 1.1014–5 Gain or loss.

* * * * *

(c) *Sale or other disposition of a term interest in a tax-exempt trust*—(1) *In general*. In the case of any sale or other disposition by a taxable beneficiary of a term interest (as defined in § 1.1001–1(f)(2)) in a tax-exempt trust (as described in paragraph (c)(2) of this section) to which section 1001(e)(3) applies, the taxable beneficiary's share of adjusted uniform basis, determined as of (and immediately before) the sale or disposition of that interest, is—

(i) That part of the adjusted uniform basis assignable to the term interest of the taxable beneficiary under the rules of paragraph (a) of this section reduced, but not below zero, by

(ii) An amount determined by applying the same actuarial share applied in paragraph (c)(1)(i) of this section to the sum of—

(A) The trust's undistributed net ordinary income within the meaning of section 664(b)(1) and § 1.664–1(d)(1)(ii)(*a*)(*1*) for the current and prior taxable years of the trust, if any; and

(B) The trust's undistributed net capital gains within the meaning of section 664(b)(2) and § 1.664–1(d)(1)(ii)(*a*)(*2*) for the current and prior taxable years of the trust, if any.

(2) *Tax-exempt trust defined*. For purposes of this section, the term *tax-exempt trust* means a charitable remainder annuity trust or a charitable remainder unitrust as defined in section 664.

(3) *Taxable beneficiary defined*. For purposes of this section, the term *taxable beneficiary* means any person other than an organization described in section 170(c) or exempt from taxation under section 501(a).

(4) *Effective/applicability date*. This paragraph (c) and paragraph (d), *Example 7* and *Example 8*, of this section apply to sales and other dispositions of interests in tax-exempt trusts occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014**.**

(d) * * *

Example 7. (a) Grantor creates a charitable remainder unitrust (CRUT) on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRUT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor's basis in the shares of X stock used to fund CRUT is $10x. On Date 2, CRUT sells the X stock for $100x. The $90x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRUT uses the $100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for $110x. The $10x of gain on the sale of the Y stock is exempt from income tax under section 664(c)(1). On Date 5, CRUT uses the $110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT's basis in its assets is $110x and CRUT's total undistributed net capital gains are $100x.

(c) Later, when the fair market value of CRUT's assets is $150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives $100x for the retained unitrust interest, and Charity receives $50x for its interest. Because the entire interest in CRUT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained unitrust interest in CRUT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $100x, over Grantor's adjusted basis in the interest.

(d) Grantor's adjusted basis in the unitrust interest in CRUT is that portion of CRUT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014–5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRUT's adjusted uniform basis in its sole asset, the Z stock, is $110x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRUT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031–7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRUT's $0 of undistributed net ordinary income and its $100x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031–7 of this chapter to the full $110x of basis.

Example 8. (a) Grantor creates a charitable remainder annuity trust (CRAT) on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor funds CRAT with shares of X stock having a basis of $50x. On Date 2, CRAT sells the X stock for $150x. The $100x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRAT distributes $10x to Grantor, and uses the remaining $140x of net proceeds from its sale of the X stock to purchase Y stock. Grantor treats the $10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount described in section 664(b)(2) and § 1.664–1(d) is $90x.

(c) On Date 4, when the fair market value of CRAT's assets, which consist entirely of the Y stock, is still $140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives $126x for the retained annuity interest, and Charity receives $14x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained annuity interest in CRAT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $126x, over Grantor's adjusted basis in that interest.

(d) Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014–5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is $140x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031–7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRAT's $0 of undistributed net ordinary income and its $90x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031–7 of this chapter to determine its actuarial share of the full $140x of basis.

John Dalrymple
Deputy Commissioner for Services and Enforcement.

(Filed by the office of the Federal Register on January 16, 2014, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2014, 79 F.R. 3142)

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–05

This announcement serves notice to donors that on August 26, 2013, the United States Tax Court declared that, effective July 10, 2000, the organization listed below is not recognized as an organization described in I.R.C. section

501(c)(3) and is not exempt from taxation under I.R.C. section 501(a).

Partners in Charity, Inc.
West Dundee, IL

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–06

This announcement serves notice to donors that on September 18, 2013, the United States Tax Court entered a stipulated decision that that the organization listed below is recognized as an organization described in section 501(c)(3), and is exempt from tax under section 501(a).

Christian Credit Outreach, Inc.
Franklin OH

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–07

This announcement serves notice to donors that on January 29, 2013, the United States Tax Court entered a stipulated decision. Effective December 22, 2000, the organization listed below is not qualified as an organization described in I.R.C. § 501(c)(3), as amended, is not exempt from taxation under I .R .C . § 501(a), and is not an organization described in I .R .C . § 170(c)(2).

The Hope and Dreams Foundation,
Palo Alto, CA

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–08

This announcement serves notice to donors that on July 9, 2013, the United States Tax Court entered an order and decision that, effective January 1, 2005, the organization listed below is not recognized as an organization described in section 501(c)(3), is not exempt from tax under section 501(a), and is not an organization described in section 170(c)(2).

First Step, Inc.
Manahawkin, NJ

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–09

This announcement serves notice to donors that on February 22, 2013, in the United States Tax Court a law suit was filed that, effective January 1, 2002, the organization listed below is not qualified as an organization described in I.R.C. § 501(c)(3) and is not exempt from taxation under I.R.C. § 501(a).

Congressional District Programs,
Falls Church, VA

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–10

This announcement serves notice to donors that on August 26, 2013, the United States Tax Court declared that, effective July 1, 2002, the organization listed below is not recognized as an organization described in I.R.C. section 501(c)(3) and is not exempt from taxation under I.R.C. section 501(a).

Capital Gymnastics, Inc.
Springfield, VA

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

Announcement 2014–11

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

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

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on ??, 2014, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

BCD & R Society
Moraga, CA

Carolina Children's Fund, Inc.
Columbia, SC

Consumer Credit Consultants, Inc.
Downey, CA

Daniel Jarvis Home Health Agency, Inc.
Bryan, TX

El Cucuy Foundation
Los Angeles, CA

The Finch Foundation
Modesto, CA

Old Fashioned Franchise Association
Dublin, OH

The Patrick Henry Center for Individual Liberty
Manassas, VA

San Diego County Estates Timeshare Owners Association
Anaheim, CA

Southern California Burmese Association
Monterey Park, CA

Notice of Disposition of Declaratory Judgment Proceedings under Section 7428

Announcement 2014–12

This announcement serves notice to donors that on August 7, 2013, in the United States Tax Court a law suit was filed that, effective January 1, 2006, the organization listed below is not qualified as an organization described in I.R.C. § 501(c)(3) and is not exempt from taxation under I.R.C. § 501(a).

Life Extension Foundation, Inc.
Ft. Lauderdale, FL

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]

Bulletins 2014–1 through 2014–6

Announcements

Notices

Proposed Regulations

Revenue Procedures

Revenue Rulings

Revenue Rulings—Continued

Treasury Decisions

[1]A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2013–27 through 2013–52 is in Internal Revenue Bulletin 2013–52, dated December 23, 2013.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2014–1 through 2014–6

Notices:

2006-109
Modified by
Notice 2014-4, 2014-2 I.R.B. *274*

2009-78
Superseded by
T.D. 9654 2014-6 I.R.B. *461*

2013-17
Amplified by
Notice 2014-1, 2014-2 I.R.B. *270*

Revenue Procedures:

2003-49
Modified and superseded by
Rev. Proc. 2014-14, 2014-2 I.R.B. *295*

2011-44
Modified and Superseded by
Rev. Proc. 2014-11, 2014-3 I.R.B. *411*

2011-49
Modified by
Rev. Proc. 2014-6, 2014-1 I.R.B. *198*

2013-1
Superseded by
Rev. Proc. 2014-1, 2014-1 I.R.B. *1*

2013-2
Superseded by
Rev. Proc. 2014-2, 2014-1 I.R.B. *90*

2013-3
Superseded by
Rev. Proc. 2014-3, 2014-1 I.R.B. *111*

2013-4
Superseded by
Rev. Proc. 2014-4, 2014-1 I.R.B. *125*

2013-5
Superseded by
Rev. Proc. 2014-5, 2014-1 I.R.B. *169*

2013-6
Superseded by
Rev. Proc. 2014-6, 2014-1 I.R.B. *198*

2013-7
Superseded by
Rev. Proc. 2014-7, 2014-1 I.R.B. *238*

Revenue Procedures—Continued:

2013-8
Superseded by
Rev. Proc. 2014-8, 2014-1 I.R.B. *242*

2013-9
Superseded by
Rev. Proc. 2014-9, 2014-2 I.R.B. *281*

2013-10
Superseded by
Rev. Proc. 2014-10, 2014-2 I.R.B. *293*

2013-32
Superseded in part by
Rev. Proc. 2014-1, 2014-1 I.R.B. *1*, and
Rev. Proc. 2014-3, 2014-1 I.R.B. *111*

Proposed Regulations:

209054-87
A portion withdrawn by
REG-113350-13 2014-3 I.R.B. *440*

[1]A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2013–27 through 2013–52 is in Internal Revenue Bulletin 2013–52, dated December 23, 2013.

INDEX

Internal Revenue Bulletins 2014–1 through 2014–6

The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the parentheses refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:

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

EMPLOYEE PLANS

EMPLOYMENT TAX

ESTATE TAX

EXCISE TAX

EXEMPT ORGANIZATIONS

INCOME TAX

INCOME TAX—Cont.

Internal Revenue Service
Washington, DC 20224

Official Business
Penalty for Private Use, $300

INTERNAL REVENUE BULLETIN

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

CUMULATIVE BULLETINS

The contents of the weekly Bulletins were consolidated semiannually into permanent, indexed, Cumulative Bulletins through the 2008–2 edition.

INTERNAL REVENUE BULLETINS ON CD-ROM

Internal Revenue Bulletins are available annually as part of Publication 1796 (Tax Products CD-ROM). The CD-ROM can be purchased from National Technical Information Service (NTIS) on the Internet at *www.irs.gov/cdorders* (discount for online orders) or by calling 1-877-233-6767. The first release is available in mid-December and the final release is available in late January.

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 IRS Bulletin Unit, SE:W:CAR:MP:P:SPA, Washington, DC 20224.