Internal Revenue Code and Regulations

Selected Sections

2026

Introduction

This book was generated from the website https://www.lawskypracticeproblems.org/codeandregs, which was coded by Sarah Lawsky, a professor at the University of Illinois College of Law.

This book contains the following materials. It is designed for tax courses taught in 2026.

Edited Table of Contents

The edited table of contents is not the table of contents of this volume. Rather, it is an edited table of contents of the entire Internal Revenue Code (USC title 26), to provide a sense of the structure of the Code.

Inflation-Adjusting Revenue Procedure

This revenue procedure, Rev. Proc. 2025-32, provides inflation adjustments for 2026.

Depreciation Revenue Procedure (Excerpts)

This revenue procedure, Rev. Proc. 87-57, provides tables to assist with determining depreciation.

Selected Sections of the Internal Revenue Code

The selected sections of the Internal Revenue Code are from a government website, https://uscode.house.gov/download/download.shtml. This Code is up to date as of December 1, 2025. At that time, the US Code online was current through Public Law 119-36, and there were no pending changes that amended Title 26.

Selected Sections of Regulations

The selected sections of the regulations, 26 CFR, are from a government website, https://www.ecfr.gov/current/title-26/. These regulations are up to date as of December 1, 2025. At that time, Title 26 of the CFR had been last amended on October 2, 2025.

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UNITED STATES CODE

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[1] Unless otherwise specified, all references to "section" or "§" are to provisions of the Internal Revenue Code.

SECTION 1. PURPOSE

This revenue procedure modifies certain sections of Rev. Proc. 2024-40, 2024-45 I.R.B. 1100, to reflect the amendments to the Internal Revenue Code (Code) by Public Law 119-21, 139 Stat. 72 (July 4, 2025), commonly known as the One, Big, Beautiful Bill Act (OBBBA). This revenue procedure sets forth inflation-adjusted items for 2026 for various Code provisions as in effect on October 9, 2025.

The inflation-adjusted items for the Code sections set forth in section 4 of this revenue procedure are generally determined by reference to § 1(f). To the extent amendments to the Code are enacted for 2025 or 2026 after October 9, 2025, taxpayers should consult additional guidance to determine whether these adjustments remain applicable for 2026.

SECTION 2. CHANGES

.01 Section 70101 of the OBBBA amends § 1(j) to make the tax rate tables that were effective for taxable years beginning after December 31, 2017, and before January 1, 2026, permanent. The existing seven tax rates of 10%, 12%, 22%, 24%, 32%, 35%,

and 37% remain in effect for individual taxpayers. The existing four tax rates of 10%, 24%, 35%, and 37% remain in effect for estates and trusts.

.02 Section 70402 of the OBBBA adds § 23(a)(4) which provides that so much of the credit allowed under § 23(a)(1) as does not exceed $5,000 is treated as a refundable credit. This amount is adjusted for inflation for taxable years beginning after December 31, 2025.

.03 Section 70104 of the OBBBA amends § 24 to make the increased and expanded child tax credit under § 24(h) that were effective for taxable years beginning after December 31, 2017, and before January 1, 2026, permanent. In addition, the OBBBA amends § 24(h)(2) to provide that the maximum amount of child tax credit is $2,200 for any taxable year beginning in 2025. This amount is adjusted for inflation for taxable years beginning after December 31, 2025.

.04 Section 71305 of the OBBBA removes § 36B(f)(2)(B), which limited the tax increase from excess advance payments for certain households, effective for taxable years beginning after December 31, 2025. Accordingly, the inflation adjustment to § 36B(f)(2)(B) is removed from this revenue procedure.

.05 Section 70422(a) of the OBBBA amends § 42(h)(3)(I) to increase the amount used under § 42(h)(3)(C)(ii) to calculate the State housing credit ceiling for calendar years beginning after December 31, 2025.

.06 Section 70401 of the OBBBA amends § 45F to increase the amount of employer provided childcare credit and provide for adjustment of the maximum amount of the allowable credit for inflation. Section 70401(b) of the OBBBA amends § 45F(b)(2) by increasing the maximum credit amounts to $500,000 ($600,000 if the employer is an

eligible small business) for taxable years beginning after December 31, 2025. These amounts will be adjusted for inflation for taxable years beginning after December 31, 2026.

.07 Section 70107 of the OBBBA amends § 55(d)(4) to make the temporary increases of the exemption amounts and the phaseout threshold amounts that were effective for taxable years beginning after December 31, 2017, and before January 1, 2026, permanent. Section 55(d)(4)(B) as amended provides that the $1,000,000 amount described in § 55(d)(4)(A)(ii)(I) is not adjusted for inflation for any taxable year beginning before January 1, 2027.

.08 Section 70102 of the OBBBA amends § 63(c)(7) to make the temporary increases of the basic standard deduction amounts provided in § 63(c)(2) that were effective for taxable years beginning after December 31, 2017, and before January 1, 2026, permanent, and further increased the base amounts. As a result, § 63(c)(7) as amended by the OBBBA provides that, for taxable years beginning after December 31, 2024, the basic standard deduction amounts provided in § 63(c)(2) are increased to $15,750 for single individuals and married individuals filing separate returns; $23,625 for heads of households; and $31,500 for married individuals filing a joint return and surviving spouses. These amounts are adjusted for inflation for taxable years beginning after 2025. See section 3 of this revenue procedure for removal of section 2.15(1) of Rev. Proc. 2024-40.

.09 Section 70412 of the OBBBA amends § 127(c)(1)(B) to make the temporary expansion of the term "educational assistance" to include employer payments of principal or interest on any qualified education loan made before January 1, 2026,

permanent. The maximum exclusion amount of $5,250 will be adjusted for inflation for taxable years beginning after 2026.

.10 Section 70306 of the OBBBA amends § 179 by increasing the maximum amount a taxpayer may expense under § 179(b)(1) and the phaseout threshold amount under § 179(b)(2). The OBBBA amendments to § 179 apply to property placed in service in taxable years beginning after December 31, 2024. Under § 179(b)(1), the maximum amount allowable is $2,500,000. Under § 179(b)(2), the $2,500,000 amount is reduced by the amount by which the cost of § 179 property placed in service during the taxable year exceeds $4,000,000, but not below $0. These amounts are adjusted for inflation for taxable years beginning after December 31, 2025. See section 3 of this revenue procedure for removal of section 2.25 of Rev. Proc. 2024-40.

.11 Section 70507 of the OBBBA terminated § 179D for property the construction of which begins after June 30, 2026.

.12 Section 70105 of the OBBBA amended § 199A(i) to add a minimum deduction of $400. Additionally, a taxpayer will be required to have a minimum of $1,000 of qualified business income to be eligible for the deduction, effective for taxable years beginning after December 31, 2025. The $400 and $1,000 amounts in § 199A(i) will be adjusted for inflation for taxable years beginning after 2026.

13 Section 70115 of the OBBBA amended § 529A(b)(2)(B)(i) to vary the manner in which the aggregate annual limitation on contributions made after December 31, 2025, is adjusted for inflation from that provided in § 2503(b). Accordingly, the inflation adjustment to the amount under § 529A(b)(2)(B)(i) is separately added to this revenue procedure.

.14 Section 70106 of the OBBBA amends § 2010(c)(3) by increasing the basic exclusion amount to $15,000,000 for calendar year 2026. The basic exclusion amount is a component of the applicable exclusion amount described in § 2010(c)(2) and is used in determining the applicable credit amount against estate tax described in § 2010(c)(1) and the applicable credit amount against gift tax described in § 2505(a)(1). For calendar year 2026, the generation-skipping transfer exemption amount under § 2631(c) is equal to $15,000,000. These numbers are adjusted for inflation for taxable years beginning after December 31, 2026. The basic exclusion amount will be adjusted for inflation for calendar year 2027 and future years.

.15 Section 70433(a) of the OBBBA amends § 6041(a) to increase the threshold amount for reporting payments made in the course of a trade or business. Section 70433(c) and (d) of the OBBBA amends §§ 6041A(a)(2) (requiring reporting for remuneration for services) and 3406(b)(6) (requiring backup withholding for payments reportable under § 6041), respectively, to cross-reference the § 6041(a) threshold. For payments made after December 31, 2025, the base threshold under section 6041(a) is $2,000. This base threshold amount is adjusted for inflation for returns required to be filed in calendar year 2027.

.16 Section 70421(d)(2)(A) of the OBBBA adds § 6726, which, effective for taxable years beginning after July 4, 2025, imposes a penalty for failure to file a return in the time and manner prescribed for a qualified opportunity fund or qualified rural opportunity fund under § 6039K. Section 6726(b) provides for a penalty of $500 per day with a maximum penalty of $10,000 per return ($50,000 if the gross assets of the fund are greater than $10,000,000). Section 6726(c) provides penalties of $2,500 per day with a

maximum penalty is $50,000 per return ($250,000 if the gross assets of the fund are greater than $10,000,000), if the failure to file is due to intentional disregard. These amounts are effective for taxable years that begin after the enactment of the OBBBA. These amounts are adjusted for inflation for returns required to be filed in calendar years beginning after 2026.

SECTION 3. 2025 ADJUSTED ITEMS AS MODIFIED, SUPERSEDED OR SUPPLEMENTED

.01 Removal of Section 2.15(1) of Rev. Proc. 2024-40. Section 63(c)(7) as amended by the OBBBA provides the standard deduction amounts under § 63(c)(2) for any taxable year beginning in 2025 as follows:

Filing Status	Standard Deduction
Married Individuals Filing Joint Returns and Surviving Spouses (§ 1(j)(2)(A))	$31,500
Heads of Households (§ 1(j)(2)(B))	$23,625
Unmarried Individuals (other than Surviving Spouses and Heads of Households) (§ 1(j)(2)(C))	$15,750
Married Individuals Filing Separate Returns (§ 1(j)(2)(D))	$15,750

Accordingly, section 2.15(1) of Rev. Proc. 2024-40 is removed.

.02 Removal of Section 2.25 of Rev. Proc. 2024-40.

(1) Section 179(b)(1) as amended by the OBBBA provides that the maximum amount allowable for expensing under § 179 is $2,500,000 for any taxable year beginning in 2025. Section 179(b)(2) as amended by the OBBBA provides that, for any taxable year beginning in 2025, the $2,500,000 amount is reduced by the amount by which the cost of § 179 property placed in service during the taxable year exceeds $4,000,000, but not below $0. Accordingly, section 2.25 of Rev. Proc. 2024-40 is

removed.

(2) Conforming change. The Table of Contents of Rev. Proc. 2024-40 is modified by removing the entry for section 2.25, "Election to Expense Certain Depreciable Assets."

SECTION 4. 2026 ADJUSTED ITEMS

.01 Tax Rate Tables. For taxable years beginning in 2026, the tax rate tables under § 1 are as follows:

TABLE 1 - Section 1(j)(2)(A) –Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is:	The Tax Is:
Not over $24,800	10% of the taxable income
Over $24,800 but not over $100,800	$2,480 plus 12% of the excess over $24,800
Over $100,800 but not over $211,400	$11,600 plus 22% of the excess over $100,800
Over $211,400 but not over $403,550	$35,932 plus 24% of the excess over $211,400
Over $403,550 but not over $512,450	$82,048 plus 32% of the excess over $403,550
Over $512,450 but not over $768,700	$116,896 plus 35% of the excess over $512,450
Over $768,700	$206,583.50 plus 37% of the excess over $768,700

TABLE 2 - Section 1(j)(2)(B) – Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $17,700	10% of the taxable income
Over $17,700 but not over $67,450	$1,770 plus 12% of the excess over $17,700
Over $67,450 but not over $105,700	$7,740 plus 22% of the excess over $67,450

Over $105,700 but not over $201,750	$16,155 plus 24% of the excess over $105,700
Over $201,750 but not over $256,200	$39,207 plus 32% of the excess over $201,750
Over $256,200 but not over $640,600	$56,631 plus 35% of the excess over $256,200
Over $640,600	$191,171 plus 37% of the excess over $640,600

TABLE 3 - Section 1(j)(2)(C) – Unmarried Individuals (other than Surviving Spouses and Heads of Households)

If Taxable Income Is:	The Tax Is:
Not over $12,400	10% of the taxable income
Over $12,400 but not over $50,400	$1,240 plus 12% of the excess over $12,400
Over $50,400 but not over $105,700	$5,800 plus 22% of the excess over $50,400
Over $105,700 but not over $201,775	$17,966 plus 24% of the excess over $105,700
Over $201,775 but not over $256,225	$41,024 plus 32% of the excess over $201,775
Over $256,225 but not over $640,600	$58,448 plus 35% of the excess over $256,225
Over $640,600	$192,979.25 plus 37% of the excess over $640,600

TABLE 4 - Section 1(j)(2)(D) – Married Individuals Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $12,400	10% of the taxable income
Over $12,400 but not over $50,400	$1,240 plus 12% of the excess over $12,400
Over $50,400 but not over $105,700	$5,800 plus 22% of the excess over $50,400

Over $105,700 but not over $201,775	$17,966 plus 24% of the excess over $105,700
Over $201,775 but not over $256,225	$41,024 plus 32% of the excess over $201,775
Over $256,225 but not over $384,350	$58,448 plus 35% of the excess over $256,225
Over $384,350	$103,291.75 plus 37% of the excess over $384,350

TABLE 5 - Section 1(j)(2)(E) – Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $3,300	10% of the taxable income
Over $3,300 but not over $11,700	$330 plus 24% of the excess over $3,300
Over $11,700 but not over $16,000	$2,346 plus 35% of the excess over $11,700
Over $16,000	$3,851 plus 37% of the excess over $16,000

.02 Unearned Income of Minor Children Subject to the "Kiddie Tax". For taxable years beginning in 2026, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $1,350. This $1,350 amount is the same as the amount provided in § 63(c)(5)(A), as adjusted for inflation. The same $1,350 amount is used for purposes of § 1(g)(7) to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the "kiddie tax." For example, one of the requirements for the parental election is that a child's gross income is more than the amount referred to in § 1(g)(4)(A)(ii)(I) but less than 10 times that amount; thus, a child's gross income for 2026 must be more than $1,350 but less than $13,500.

.03 Maximum Capital Gains Rate (§ 1(h), § 1(j)(5)). For taxable years beginning in 2026, the maximum zero rate amounts and maximum 15 percent rate amounts under § 1(j)(5)(B), as adjusted for inflation, are as follows:

Filing Status	Maximum Zero Rate Amount	Maximum15% Rate Amount
Married Individuals Filing Joint Returns and Surviving Spouse	$98,900	$613,700
Married Individuals Filing Separate Returns	$49,450	$306,850
Heads of Household	$66,200	$579,600
All Other Individuals	$49,450	$545,500
Estates and Trusts	$3,300	$16,250

.04 Adoption Credit.

(1) Adoption Credit for Children with Special needs. For taxable years beginning in 2026, under § 23(a)(3), the credit allowed for an adoption of a child with special needs is $17,670.

(2) Adoption Credit Limitation. For taxable years beginning in 2026, under § 23(b)(1), the maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to $17,670. The available adoption credit begins to phase out under § 23(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $265,080 and is completely phased out for taxpayers with modified adjusted gross income of $305,080 or more. See section 4.18 of this revenue procedure for the adjusted items relating to adoption assistance programs.

(3) Refundable Portion. For taxable years beginning in 2026, the amount used in § 23(a)(4) to determine the amount of the credit under § 23 that may be refundable is $5,120.

.05 Child Tax Credit.

(1) Maximum amount of the credit. For taxable years beginning in 2026, the maximum amount of the credit allowed under § 24(a) is $2,200.

(2) Refundable portion. For taxable years beginning in 2026, the amount used in § 24(d)(1)(A) to determine the amount of the credit under § 24 that may be refundable is $1,700.

.06 Earned Income Credit.

(1) In general. For taxable years beginning in 2026, the following amounts are used to determine the earned income credit under § 32(b). The "earned income amount" is the amount of earned income at or above which the maximum amount of the earned income credit is allowed. The "threshold phaseout amount" is the amount of adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The "completed phaseout amount" is the amount of adjusted gross income (or, if greater, earned income) at or above which no credit is allowed. The threshold phaseout amounts and the completed phaseout amounts shown in the table below for married taxpayers filing a joint return include the increase provided in § 32(b)(2)(B), as adjusted for inflation for taxable years beginning in 2026. The threshold phaseout amounts and the completed phaseout amounts shown in the table below for taxpayers with all other filing statuses also apply to married taxpayers who are not filing a joint return and satisfy the special rules for separated spouses in § 32(d).

Item	Number of Qualifying Children: One	Two	Three or More	None
Earned Income Amount	$13,020	$18,290	$18,290	$8,680
Maximum Amount of Credit	$4,427	$7,316	$8,231	$664
Threshold Phaseout Amount (Married Filing Jointly)	$31,160	$31,160	$31,160	$18,140
Completed Phaseout Amount (Married Filing Jointly)	$58,863	$65,899	$70,244	$26,820
Threshold Phaseout Amount (All other filing statuses)	$23,890	$23,890	$23,890	$10,860
Completed Phaseout Amount (All other filing statuses)	$51,593	$58,629	$62,974	$19,540

The instructions for the Form 1040 series provide tables showing the amount of the earned income credit for each type of taxpayer.

(2) Excessive Investment Income. For taxable years beginning in 2026, the earned income tax credit is not allowed under § 32(i) if the aggregate amount of certain investment income exceeds $12,200.

.07 Rehabilitation Expenditures Treated as Separate New Building. For calendar year 2026, the per low-income unit qualified basis amount under § 42(e)(3)(A)(ii)(II) is $8,700.

.08 Low-Income Housing Credit. For calendar year 2026, the amount used under § 42(h)(3)(C)(ii) to calculate the State housing credit ceiling for the low-income housing credit is the greater of (1) $3.416 multiplied by the State population, or (2) $3,953,600.

.09 Employee Health Insurance Expense of Small Employers. For taxable years beginning in 2026, the dollar amount in effect under § 45R(d)(3)(B) is $34,100. This amount is used under § 45R(c) for limiting the small employer health insurance credit and under § 45R(d)(1)(B) for determining who is an eligible small employer for purposes of the credit.

.10 Exemption Amounts for Alternative Minimum Tax. For taxable years beginning in 2026, the exemption amounts under § 55(d)(1) are:

Filing status	Exemption amount
Joint Returns or Surviving Spouses	$140,200
Unmarried Individuals (other than Surviving Spouses)	$90,100
Married Individuals Filing Separate Returns	$70,100
Estates and Trusts	$31,400

For taxable years beginning in 2026, under § 55(b)(1), the excess taxable income above which the 28 percent tax rate applies is:

Filing status	Excess taxable income
Married Individuals Filing Separate Returns	$122,250
All Other Taxpayers	$244,500

For taxable years beginning in 2026, the amounts used under § 55(d)(2) to determine the phaseout of the exemption amounts are:

Filing status	Threshold Phaseout Amount	Complete Phaseout Amount
Joint Returns or Surviving Spouses	$1,000,000	$1,280,400
Unmarried Individuals (other than Surviving Spouses)	$500,000	$680,200
Married Individuals Filing Separate Returns	$500,000	$640,200
Estates and Trusts	$104,800	$167,600

.11 Alternative Minimum Tax Exemption for a Child Subject to the "Kiddie Tax." For taxable years beginning in 2026, for a child to whom the § 1(g) "kiddie tax" applies, the exemption amount under §§ 55(d) and 59(j) for purposes of the alternative minimum tax under § 55 may not exceed the sum of (1) the child's earned income for the taxable year, plus (2) $9,750.

.12 Certain Expenses of Elementary and Secondary School Teachers. For taxable years beginning in 2026, under § 62(a)(2)(D), the amount of the deduction allowed under § 162 that consists of expenses paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom is $350.

.13 Transportation Mainline Pipeline Construction Industry Optional Expense Substantiation Rules for Payments to Employees Under Accountable Plans. For calendar year 2026, an eligible employer may pay certain welders and heavy equipment mechanics an amount up to $23 per hour for rig-related expenses that are deemed substantiated under an accountable plan if paid in accordance with Rev. Proc. 2002-41,

2002-1 C.B. 1098. If the employer provides fuel or otherwise reimburses fuel expenses, an amount up to $14 per hour is deemed substantiated if paid in accordance with Rev. Proc. 2002-41.

.14 Standard Deduction.

(1) In general. For taxable years beginning in 2026, the standard deduction amounts under § 63(c)(2) are as follows:

Filing Status	Standard Deduction
Married Individuals Filing Joint Returns and Surviving Spouses (§ 1(j)(2)(A))	$32,200
Heads of Households (§ 1(j)(2)(B))	$24,150
Unmarried Individuals (other than Surviving Spouses and Heads of Households) (§ 1(j)(2)(C))	$16,100
Married Individuals Filing Separate Returns (§ 1(j)(2)(D))	$16,100

(2) Dependent. For taxable years beginning in 2026, the standard deduction amount under § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,350, or (2) the sum of $450 and the individual's earned income.

(3) Aged or blind. For taxable years beginning in 2026, the additional standard deduction amount under § 63(f) for the aged or the blind is $1,650. The additional standard deduction amount is increased to $2,050 if the individual is also unmarried and not a surviving spouse.

.15 Cafeteria Plans. For taxable years beginning in 2026, the dollar limitation under § 125(i) on voluntary employee salary reductions for contributions to health flexible

spending arrangements is $3,400. If the cafeteria plan permits the carryover of unused amounts, the maximum carryover amount is $680.

.16 Qualified Transportation Fringe Benefit. For taxable years beginning in 2026, the monthly limitation under § 132(f)(2)(A) regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $340. The monthly limitation under § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $340.

.17 Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses. For taxable years beginning in 2026, the exclusion under § 135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above $152,650 for joint returns and $101,800 for all other returns. The exclusion is completely phased out for modified adjusted gross income of $182,650 or more for joint returns and $116,800 or more for all other returns.

.18 Adoption Assistance Programs. For taxable years beginning in 2026, under § 137(a)(2), the amount that can be excluded from an employee's gross income for the adoption of a child with special needs is $17,670. For taxable years beginning in 2026, under § 137(b)(1) the maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for adoptions by the employee is $17,670. The amount excludable from an employee's gross income begins to phase out under § 137(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $265,080 and is completely phased out for taxpayers with modified adjusted

gross income of $305,080 or more. See section 4.04 of this revenue procedure for the adjusted items relating to the adoption credit.

.19 Private Activity Bonds Volume Cap. For calendar year 2026, the amounts used under § 146(d) to calculate the State ceiling for the volume cap for private activity bonds is the greater of (1) $135 multiplied by the State population, or (2) $397,625,000.

.20 Loan Limits on Agricultural Bonds. For calendar year 2026, the loan limit amount on agricultural bonds under § 147(c)(2)(A) for first-time farmers is $682,700.

.21 General Arbitrage Rebate Rules. For bond years ending in 2026, the amount of the computation credit determined under § 1.148-3(d)(4) of the Income Tax Regulations is $2,170.

.22 Safe Harbor Rules for Broker Commissions on Guaranteed Investment Contracts or Investments Purchased for a Yield Restricted Defeasance Escrow. For calendar year 2026, under § 1.148-5(e)(2)(iii)(B)(1) of the Income Tax Regulations, a broker's commission or similar fee for the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is reasonable if (1) the amount of the fee that the issuer treats as a qualified administrative cost does not exceed the lesser of (A) $51,000, and (B) 0.2 percent of the computational base (as defined in § 1.148-5(e)(2)(iii)(B)(2)) or, if more, $5,000; and (2) for any issue, the issuer does not treat more than $145,000 in brokers' commissions or similar fees as qualified administrative costs for all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue.

.23 Gross Income Limitation for a Qualifying Relative. For taxable years beginning in 2026, the exemption amount referred to in § 152(d)(1)(B) is $5,300.

.24 Election to Expense Certain Depreciable Assets. For taxable years beginning in 2026, under § 179(b)(1), the aggregate cost of any § 179 property that a taxpayer elects to treat as an expense cannot exceed $2,560,000 and, under § 179(b)(5)(A), the cost of any sport utility vehicle that may be taken into account under § 179 cannot exceed $32,000. Under § 179(b)(2), the $2,560,000 limitation under § 179(b)(1) is reduced (but not below zero) by the amount by which the cost of § 179 property placed in service during the 2026 taxable year exceeds $4,090,000.

.25 Energy Efficient Commercial Buildings Deduction. For taxable years beginning in 2026, the applicable dollar value used to determine the maximum allowance of the deduction under § 179D(b)(2) is $0.59 increased (but not above $1.19) by $0.02 for each percentage point by which the total annual energy and power costs for the buildings are certified to be reduced by a percentage greater than 25 percent. For taxable years beginning in 2026, the applicable dollar value used to determine the increased deduction amount for certain property under § 179D(b)(3) is $2.97 increased (but not above $5.94) by $0.12 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

.26 Qualified Business Income. For taxable years beginning in 2026, the threshold amounts under § 199A(e)(2) and phase-in range amounts under § 199A(b)(3)(B) and § 199A(d)(3)(A) are:

Filing Status	Threshold amount	Phase-in range amount
Married Individuals Filing Joint Returns	$403,500	$553,500
Married Individuals Filing Separate Returns	$201,775	$276,775
All Other Returns	$201,750	$276,750

.27 Eligible Long-Term Care Premiums. For taxable years beginning in 2026, the limitations under § 213(d)(10), regarding eligible long-term care premiums includible in the term "medical care" are as follows:

Attained Age Before the Close of the Taxable Year	Limitation on Premiums
40 or less	$500
More than 40 but not more than 50	$930
More than 50 but not more than 60	$1,860
More than 60 but not more than 70	$4,960
More than 70	$6,200

.28 Medical Savings Accounts.

(1) Self-only coverage. For taxable years beginning in 2026, the term "high deductible health plan" as defined in § 220(c)(2)(A) means, for self-only coverage, a health plan that has an annual deductible that is not less than $2,900 and not more than $4,400, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $5,850.

(2) Family coverage. For taxable years beginning in 2026, the term "high deductible health plan" means, for family coverage, a health plan that has an annual deductible that is not less than $5,850 and not more than $8,750, and under which the

annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $10,700.

.29 Interest on Education Loans. For taxable years beginning in 2026, the $2,500 maximum deduction for interest paid on qualified education loans under § 221 begins to phase out under § 221(b)(2)(B), as adjusted for inflation, for taxpayers with modified adjusted gross income in excess of $85,000 ($175,000 for joint returns), and is completely phased out for taxpayers with modified adjusted gross income of $100,000 or more ($205,000 or more for joint returns).

.30 Limitation on Use of Cash Method of Accounting. For taxable years beginning in 2026, a corporation or partnership meets the gross receipts test of § 448(c) for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $32,000,000.

.31 Threshold for Excess Business Loss. For taxable years beginning in 2026, in determining a taxpayer's excess business loss, the amount under § 461(l)(3)(A)(ii)(II) is $256,000 ($512,000 for joint returns).

.32 Treatment of Dues Paid to Agricultural or Horticultural Organizations. For taxable years beginning in 2026, the limitation under § 512(d)(1), regarding the exemption of annual dues required to be paid by a member to an agricultural or horticultural organization, is $212.

.33 Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.

(1) Low cost article. For taxable years beginning in 2026, for purposes of defining the term "unrelated trade or business" for certain exempt organizations under § 513(h)(2), "low cost articles" are articles costing $13.90 or less.

(2) Other insubstantial benefits. For taxable years beginning in 2026, under § 170, the $5, $25, and $50 guidelines in section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987, and modified by Rev. Proc. 92-102, 1992-2 C.B. 579), for the value of insubstantial benefits that may be received by a donor in return for a contribution, without causing the contribution to fail to be fully deductible, are $13.90, $69.50 and $139, respectively.

.34 Aggregate Limitation on Contributions to ABLE Accounts. For taxable years beginning in 2026, $20,000 (instead of instead of the amount under provided in section 4.42(1) of this revenue procedure) is included in the aggregate limitation on contributions to ABLE accounts under § 529A(b)(2)(B)(i).

.35 Special Rules for Credits and Deductions. For taxable years beginning in 2026, the amount of the deduction under § 642(b)(2)(C)(i) is $5,300.

.36 Tax on Insurance Companies Other than Life Insurance Companies. For taxable years beginning in 2026, under § 831(b)(2)(A)(i) the amount of the limit on net written premiums or direct written premiums (whichever is greater) is $2,900,000 to elect the alternative tax for certain small companies under § 831(b)(1) to be taxed only on taxable investment income.

.37 Expatriation to Avoid Tax. For calendar year 2026, under § 877A(g)(1)(A), unless an exception under § 877A(g)(1)(B) applies, an individual is a covered expatriate if the individual's "average annual net income tax" under § 877(a)(2)(A) for the five taxable years ending before the expatriation date is more than $211,000.

.38 Tax Responsibilities of Expatriation. For taxable years beginning in 2026, the amount that would be includible in the gross income of a covered expatriate by reason of § 877A(a)(1) is reduced (but not below zero) by $910,000 pursuant to § 877A(a)(3).

.39 Foreign Earned Income Exclusion. For taxable years beginning in 2026, the foreign earned income exclusion amount under § 911(b)(2)(D)(i) is $132,900.

.40 Debt Instruments Arising Out of Sales or Exchanges. For calendar year 2026, a qualified debt instrument under § 1274A(b) has stated principal that does not exceed $7,462,600, and a cash method debt instrument under § 1274A(c)(2) has stated principal that does not exceed $5,330,500.

.41 Limitation on Aggregate Decrease in Value of Qualified Real Property in Decedent's Gross Estate. For an estate of a decedent dying in calendar year 2026, if the executor elects to use the special use valuation method under § 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use § 2032A for purposes of the estate tax cannot exceed $1,460,000.

.42 Annual Exclusion for Gifts and Annual Exception for Covered Gifts and Covered Bequests Received from a Covered Expatriate.

(1) For calendar year 2026, the first $19,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under § 2503 made during that year.

(2) For calendar year 2026, the first $194,000 (instead of the amount provided in paragraph (1) of this section 4.42) of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §§ 2503 and 2523(i)(2) made during that year.

(3) The tax imposed under § 2801 on the receipt of covered gifts or covered bequests from a covered expatriate shall apply only to the extent that the value of covered gifts and covered bequests received during calendar year 2026 exceeds $19,000.

.43 Tax on Arrow Shafts. For calendar year 2026, the tax imposed under § 4161(b)(2)(A) on the first sale by the manufacturer, producer, or importer of any shaft of a type used in the manufacture of certain arrows is $0.65 per shaft.

.44 Passenger Air Transportation Excise Tax. For calendar year 2026, the tax under § 4261(b)(1) on the amount paid for each domestic segment of taxable air transportation is $5.30. For calendar year 2026, the tax under § 4261(c)(1) on any amount paid (whether within or without the United States) for any international air transportation, if the transportation begins or ends in the United States, generally is $23.40. Under § 4261(c)(3), however, a lower rate of tax applies under § 4261(c)(1) to a domestic segment beginning or ending in Alaska or Hawaii, and the tax applies only to departures. For calendar year 2026, the rate of tax is $11.70.

.45 Tax on Certain Uses of Crude Oil and Petroleum Products. For calendar year 2026, the tax imposed under § 4611(a) on crude oil received at a United States refinery and petroleum products entered into the United States for consumption, use, or warehousing is $0.27 per barrel.

.46 Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures. For taxable years beginning in 2026, the annual per person, family, or entity dues limitation to qualify for the reporting exception under § 6033(e)(3) (and section 5.05 of Rev. Proc. 98-19, 1998-1 C.B. 547), regarding certain exempt organizations with nondeductible lobbying expenditures, is $147 or less.

.47 Notice of Large Gifts Received from Foreign Persons. For taxable years beginning in 2026, § 6039F authorizes the Secretary of the Treasury or the Secretary's delegate to require recipients of gifts from certain foreign persons to report these gifts if the aggregate value of gifts received in the taxable year exceeds $20,573.

.48 Persons Against Whom a Federal Tax Lien Is Not Valid. For calendar year 2026, a federal tax lien is not valid against (1) certain purchasers under § 6323(b)(4) who purchased personal property in a casual sale for less than $2,000, or (2) a mechanic's lienor under § 6323(b)(7) who repaired or improved certain residential property if the contract price with the owner is not more than $10,010.

.49 Property Exempt from Levy. For calendar year 2026, the value of property exempt from levy under § 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) cannot exceed $11,980. The value of property exempt from levy under § 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) cannot exceed $5,990.

.50 Exempt Amount of Wages, Salary, or Other Income. For taxable years beginning in 2026, the dollar amount used to calculate the amount determined under § 6334(d)(4)(B) is $5,300.

.51 Interest on a Certain Portion of the Estate Tax Payable in Installments. For an estate of a decedent dying in calendar year 2026, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under § 6601(j)) of the estate tax extended as provided in § 6166 is $1,940,000.

.52 Failure to File Tax Return. In the case of any return required to be filed in 2027, the amount of the addition to tax under § 6651(a) for failure to file an income tax return within 60 days of the due date of such return (determined with regard to any extensions of time for filing) will not be less than the lesser of $535 or 100 percent of the amount required to be shown as tax on such return.

.53 Failure to File Certain Information Returns, Registration Statements, etc. For returns required to be filed in 2027, the penalty amounts under § 6652(c) are:

(1) for failure to file a return required under § 6033(a)(1) (relating to returns by exempt organization) or § 6012(a)(6) (relating to returns by political organizations):

Scenario	Daily Penalty	Maximum Penalty
Organization (§ 6652(c)(1)(A))	$25	Lesser of $13,000 or 5% of gross receipts of the organization for the year.
Organization with gross receipts exceeding $1,339,500 (§ 6652(c)(1)(A))	$130	$66,500
Managers (§ 6652(c)(1)(B))	$10	$6,500
Public inspection of annual returns and reports (§ 6652(c)(1)(C))	$25	$13,000
Public inspection of applications for exemption and notice of status (§ 6652(c)(1)(D))	$25	No Limit

(2) for failure to file a return required under § 6034 (relating to returns by certain trust) or § 6043(b) (relating to terminations, etc., of exempt organizations):

Scenario	Daily Penalty	Maximum Penalty
Organization or trust (§ 6652(c)(2)(A))	$10	$6,500
Managers (§ 6652(c)(2)(B))	$10	$6,500
Split-Interest Trust (§ 6652(c)(2)(C)(ii))	$25	$13,000
Any trust with gross income exceeding $334,500 (§ 6652(c)(2)(C)(ii))	$130	$66,500

(3) for failure to file a disclosure required under § 6033(a)(2):

Scenario	Daily Penalty	Maximum Penalty
Tax–exempt entity (§ 6652(c)(3)(A))	$130	$66,500
Failure to comply with written demand (§ 6652(c)(3)(B)(ii))	$130	$13,000

.54 Other Assessable Penalties with Respect to the Preparation of Tax Returns for Other Persons. In the case of any failure relating to a return or claim for refund filed in 2027, the penalty amounts under § 6695 are:

Scenario	Per Return or Claim for Refund	Maximum Penalty
Failure to furnish copy to taxpayer (§ 6695(a))	$65	$33,000
Failure to sign return (§ 6695(b))	$65	$33,000
Failure to furnish identifying number (§ 6695(c))	$65	$33,000
Failure to retain copy or list (§ 6695(d))	$65	$33,000
Failure to file correct information returns (§ 6695(e))	$65 per return and item in return	$33,000
Negotiation of check (§ 6695(f))	$665 per check	No limit
Failure to be diligent in determining eligibility for head of household filing status, child tax credit, American Opportunity tax credit, and earned income credit (§ 6695(g))	$665 per failure	No limit

.55 Failure to File Partnership Return. In the case of any return required to be filed in 2027, the dollar amount used to determine the amount of the penalty under § 6698(b)(1) is $260.

.56 Failure to File S Corporation Return. In the case of any return required to be filed in 2027, the dollar amount used to determine the amount of the penalty under § 6699(b)(1) is $260.

.57 Failure to File Correct Information Returns. In the case of any failure relating to a return required to be filed in 2027, the penalty amounts under § 6721 are:

(1) for persons with average annual gross receipts for the most recent three taxable years of more than $5,000,000, for failure to file correct information returns:

Scenario	Penalty Per Return	Calendar Year Maximum
General Rule (§ 6721(a)(1))	$340	$4,191,500
Corrected on or before 30 days after required filing date (§ 6721(b)(1))	$60	$698,500
Corrected after 30th day but on or before August 1, 2026 (§ 6721(b)(2))	$130	$2,095,500

(2) for persons with average annual gross receipts for the most recent three taxable years of $5,000,000 or less, for failure to file correct information returns:

Scenario	Penalty Per Return	Calendar Year Maximum
General Rule (§ 6721(d)(1)(A))	$340	$1,397,000
Corrected on or before 30 days after required filing date (§ 6721(d)(1)(B))	$60	$244,500
Corrected after 30th day but on or before August 1, 2026 (§ 6721(d)(1)(C))	$130	$698,500

(3) for failure to file correct information returns due to intentional disregard of the filing requirement (or the correct information reporting requirement):

Scenario	Penalty Per Return	Calendar Year Maximum
Return other than a return required to be filed under §§ 6045(a), 6041A(b), 6050H, 6050I, 6050J, 6050K, or 6050L (§ 6721(e)(2)(A))	Greater of (i) $690, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Return required to be filed under §§ 6045(a), 6050K, or 6050L (§ 6721(e)(2)(B))	Greater of (i) $690, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit
Return required to be filed under § 6050I(a) (§ 6721(e)(2)(C))	Greater of (i) $34,930, or (ii) amount of cash received up to $139,500	No limit
Return required to be filed under § 6050V (§ 6721(e)(2)(D))	Greater of (i) $690, or (ii) 10% of the value of the benefit of any contract with respect to which information is required to be included on the return	No limit

.58 Failure to Furnish Correct Payee Statements. In the case of any failure relating to a statement required to be furnished in 2027, the penalty amounts under § 6722 are:

(1) for persons with average annual gross receipts for the most recent three taxable years of more than $5,000,000, for failure to furnish correct payee statements:

Scenario	Penalty Per Statement	Calendar Year Maximum
General Rule (§ 6722(a)(1))	$340	$4,191,500
Corrected on or before 30 days after required furnishing date (§ 6722(b)(1))	$60	$698,500
Corrected after 30th day but on or before August 1, 2026 (§ 6722(b)(2))	$130	$2,095,500

(2) for persons with average annual gross receipts for the most recent 3 taxable years of $5,000,000 or less, for failure to furnish correct payee statements:

Scenario	Penalty Per Statement	Calendar Year Maximum
General Rule (§ 6722(d)(1)(A))	$340	$1,397,000
Corrected on or before 30 days after required furnishing date (§ 6722(d)(1)(B))	$60	$244,500
Corrected after 30th day but on or before August 1, 2026 (§ 6722(d)(1)(C))	$130	$698,500

(3) for failure to furnish correct payee statements due to intentional disregard of the requirement to furnish a payee statement (or the correct information reporting requirement):

Scenario	Penalty Per Statement	Calendar Year Maximum
Payee statement other than a statement required under §§ 6045(b), 6041A(e) (in respect of a return required under §§ 6041A(b)), 6050H(d), 6050J(e), 6050K(b), or 6050L(c) (§ 6722(e)(2)(A))	Greater of (i) $690, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Payee statement required under §§ 6045(b), 6050K(b), or 6050L(c) (§ 6722(e)(2)(B))	Greater of (i) $690, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit

.59 Failure to Comply with Information Reporting Requirements Relating to Qualified Opportunity Funds and Qualified Rural Opportunity Funds. In the case of any return required to be filed in 2027, the penalty amount under § 6726 for failure to file a return in the time and manner prescribed for a qualified opportunity fund or qualified rural

opportunity fund under § 6039K is $510 per day with a maximum penalty of $10,000 per return ($51,000 if the gross assets of the fund are greater than $10,230,000). If the failure to file in the time and manner prescribed is due to intentional disregard, then the penalty is $2,550 per day with a maximum penalty is $51,000 per return ($255,000 if the gross assets of the fund are greater than $10,230,000).

.60 Revocation or Denial of Passport in Case of Certain Tax Delinquencies. For calendar year 2026, the amount of a serious delinquent tax debt under § 7345 is $66,000.

.61 Attorney Fee Awards. For fees incurred in calendar year 2026, the attorney fee award limitation under § 7430(c)(1)(B)(iii) is $260 per hour.

.62 Periodic Payments Received Under Qualified Long-Term Care Insurance Contracts or Under Certain Life Insurance Contracts. For calendar year 2026, the stated dollar amount of the per diem limitation under § 7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is $430.

.63 Qualified Small Employer Health Reimbursement Arrangement. For taxable years beginning in 2026, to qualify as a qualified small employer health reimbursement arrangement under § 9831(d), the arrangement must provide that the total amount of payments and reimbursements for any year cannot exceed $6,450 ($13,100 for family coverage).

SECTION 5. EFFECTIVE DATE

.01 2025 Inflation-Adjusted Items. Section 3 of this revenue procedures applies to taxable years beginning in 2025.

.02 2026 Inflation-Adjusted Items. Except as provided in section 5.03 of this revenue procedure, section 4 of this revenue procedure applies to taxable years beginning in 2026.

.03 Calendar Year Rule. Section 4 of this revenue procedure applies to transactions or events occurring in calendar year 2026 for purposes of sections 4.07 (rehabilitation expenditures treated as separate new building), 4.08 (low-income housing credit), 4.13 (transportation mainline pipeline construction industry optional expense substantiation rules for payments to employees under accountable plans), 4.19 (private activity bonds volume cap), 4.20 (loan limits on agricultural bonds), 4.21 (general arbitrage rebate rules), 4.22 (safe harbor rules for broker commissions on guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow), 4.37 (expatriation to avoid taxes), 4.40 (debt instruments arising out of sales or exchanges), 4.41 (limitation on aggregate decrease in value of qualified real property in decedent's gross estate), 4.42 (annual exclusion for gifts and annual exception for covered gifts and covered bequests received from a covered expatriate), 4.43 (tax on arrow shafts), 4.443 (passenger air transportation excise tax), 4.45 (tax on certain uses of crude oil and petroleum products), 4.48 (persons against whom a federal tax lien is not valid), 4.49 (property exempt from levy), 4.51 (interest on a certain portion of the estate tax payable in installments), 4.60 (revocation or denial of passport in case of certain tax delinquencies), 4.61 (attorney fee awards), and 4.62 (periodic payments received under

qualified long-term care insurance contracts or under certain life insurance contracts) of this revenue procedure.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2024-40 is modified.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Michael Finn of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Finn at (202) 317-4718 (not a toll-free call).

Revenue Procedure 87-57
Excerpts

From Revenue Procedure 87-57

8. OPTIONAL TABLES

.01. This section contains optional depreciation tables that may be used by certain taxpayers in computing annual depreciation allowances under section 168 of the Code. The depreciation tables may be used with respect to any item of property placed in service in a taxable year. For all items of property placed in service in a taxable year for which the depreciation tables are not used, depreciation allowances must be computed in the manner prescribed in sections 2-7 of this revenue procedure.

.02. The optional depreciation tables specify schedules of annual depreciation rates to be applied to the unadjusted basis of property in each taxable year. If a taxpayer uses a table to compute the annual depreciation allowance for any item of property, the taxpayer must use the table to compute the annual depreciation allowances for the entire recovery period of such property. However, a taxpayer may not continue to use the table if there are any adjustments to the basis of the property for reasons other than (1) depreciation allowed or allowable or (2) an addition or an improvement to such property that is subject to depreciation as a separate item of property. Use of the tables in this revenue procedure to compute depreciation allowances does not require the filing of any notice with the Internal Revenue Service.

Taxpayers use the appropriate table for any property based on the depreciation system, the applicable depreciation method, the applicable recovery period, and the applicable convention. The tables lists the percentage depreciation rates to be applied to the unadjusted basis of property in each taxable year.

In Tables 1-5, for the general depreciation system, the listed depreciation rates reflect the 200 percent declining balance method switching to the straight line method for property with applicable recovery periods of 3, 5, 7 or 10 years and the 150 percent declining balance method switching to straight line method for property with applicable recovery periods of 15 and 20 years.

Table 1. General Depreciation System

Applicable Depreciation Method: 200 or 150 Percent Declining Balance Switching to Straight Line

Applicable Recovery Periods: 3, 5, 7, 10, 15, 20 years

Applicable Convention: Half-year

If the Recovery Year is:	and the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	the Depreciation Rate is:					
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

Internal Revenue Code
Selected Sections

§1. TAX IMPOSED

(a) Married individuals filing joint returns and surviving spouses

There is hereby imposed on the taxable income of—

(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and

(2) every surviving spouse (as defined in section 2(a)),

a tax determined in accordance with the following table:

If taxable income is:	**The tax is:**
Not over $36,900	15% of taxable income.
Over $36,900 but not over $89,150	$5,535, plus 28% of the excess over $36,900.
Over $89,150 but not over $140,000	$20,165, plus 31% of the excess over $89,150.
Over $140,000 but not over $250,000	$35,928.50, plus 36% of the excess over $140,000.
Over $250,000	$75,528.50, plus 39.6% of the excess over $250,000.

(b) Heads of households

There is hereby imposed on the taxable income of every head of a household (as defined in section 2(b)) a tax determined in accordance with the following table:

If taxable income is:	**The tax is:**
Not over $29,600	15% of taxable income.
Over $29,600 but not over $76,400	$4,440, plus 28% of the excess over $29,600.
Over $76,400 but not over $127,500	$17,544, plus 31% of the excess over $76,400.
Over $127,500 but not over $250,000	$33,385, plus 36% of the excess over $127,500.
Over $250,000	$77,485, plus 39.6% of the excess over $250,000.

(c) Unmarried individuals (other than surviving spouses and heads of households)

There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703) a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $22,100	15% of taxable income.
Over $22,100 but not over $53,500	$3,315, plus 28% of the excess over $22,100.
Over $53,500 but not over $115,000	$12,107, plus 31% of the excess over $53,500.
Over $115,000 but not over $250,000	$31,172, plus 36% of the excess over $115,000.
Over $250,000	$79,772, plus 39.6% of the excess over $250,000.

(d) Married individuals filing separate returns

There is hereby imposed on the taxable income of every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013, a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $18,450	15% of taxable income.
Over $18,450 but not over $44,575	$2,767.50, plus 28% of the excess over $18,450.
Over $44,575 but not over $70,000	$10,082.50, plus 31% of the excess over $44,575.
Over $70,000 but not over $125,000	$17,964.25, plus 36% of the excess over $70,000.
Over $125,000	$37,764.25, plus 39.6% of the excess over $125,000.

(h) Maximum capital gains rate

(1) In general—If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—

(A) a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of—

(i) taxable income reduced by the net capital gain; or

(ii) the lesser of—

(I) the amount of taxable income taxed at a rate below 25 percent; or

(II) taxable income reduced by the adjusted net capital gain;

(B) 0 percent of so much of the adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of—

(i) the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 25 percent, over

(ii) the taxable income reduced by the adjusted net capital gain;

(C) 15 percent of the lesser of—

(i) so much of the adjusted net capital gain (or, if less, taxable income) as exceeds the amount on which a tax is determined under subparagraph (B), or

(ii) the excess of—

(I) the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 39.6 percent, over

(II) the sum of the amounts on which a tax is determined under subparagraphs (A) and (B),

(D) 20 percent of the adjusted net capital gain (or, if less, taxable income) in excess of the sum of the amounts on which tax is determined under subparagraphs (B) and (C),

(E) 25 percent of the excess (if any) of—

(i) the unrecaptured section 1250 gain (or, if less, the net capital gain (determined without regard to paragraph (11))), over

(ii) the excess (if any) of—

(I) the sum of the amount on which tax is determined under subparagraph (A) plus the net capital gain, over

(II) taxable income; and

(F) 28 percent of the amount of taxable income in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

(2) Net capital gain taken into account as investment income—For purposes of this subsection, the net capital gain for any taxable year shall be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii).

(3) Adjusted net capital gain—For purposes of this subsection, the term “adjusted net capital gain” means the sum of—

(A) net capital gain (determined without regard to paragraph (11)) reduced (but not below zero) by the sum of—

(i) unrecaptured section 1250 gain, and

(ii) 28-percent rate gain, plus

(B) qualified dividend income (as defined in paragraph (11)).

(4) 28-percent rate gain—For purposes of this subsection, the term "28-percent rate gain" means the excess (if any) of—

(A) the sum of—

(i) collectibles gain; and

(ii) section 1202 gain, over

(B) the sum of—

(i) collectibles loss;

(ii) the net short-term capital loss; and

(iii) the amount of long-term capital loss carried under section 1212(b)(1)(B) to the taxable year.

(5) Collectibles gain and loss—For purposes of this subsection—

(A) In general—The terms "collectibles gain" and "collectibles loss" mean gain or loss (respectively) from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.

(B) Partnerships, etc.—For purposes of subparagraph (A), any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible. Rules similar to the rules of section 751 shall apply for purposes of the preceding sentence.

(6) Unrecaptured section 1250 gain—For purposes of this subsection—

(A) In general—The term "unrecaptured section 1250 gain" means the excess (if any) of—

(i) the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent, over

(ii) the excess (if any) of—

(I) the amount described in paragraph (4)(B); over

(II) the amount described in paragraph (4)(A).

(B) Limitation with respect to section 1231 property—The amount described in subparagraph (A)(i) from sales, exchanges, and conversions described in section 1231(a)(3)(A) for any taxable year shall not exceed the net section 1231 gain (as defined in section 1231(c)(3)) for such year.

(7) Section 1202 gain—For purposes of this subsection, the term "section 1202 gain" means the excess of—

(A) the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a), over

(B) the gain excluded from gross income under section 1202.

(8) Coordination with recapture of net ordinary losses under section 1231—If any amount is treated as ordinary income under section 1231(c), such amount shall be allocated among the separate categories of net section 1231 gain (as defined in section 1231(c)(3)) in such manner as the Secretary may by forms or regulations prescribe.

(9) Regulations—The Secretary may prescribe such regulations as are appropriate (including regulations requiring reporting) to apply this subsection in the case of sales and exchanges by pass-thru entities and of interests in such entities.

(10) Pass-thru entity defined—For purposes of this subsection, the term "pass-thru entity" means—

(A) a regulated investment company;

(B) a real estate investment trust;

(C) an S corporation;

(D) a partnership;

(E) an estate or trust;

(F) a common trust fund; and

(G) a qualified electing fund (as defined in section 1295).

(11) Dividends taxed as net capital gain—

(A) In general—For purposes of this subsection, the term "net capital gain" means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.

(B) Qualified dividend income—For purposes of this paragraph—

(i) In general—The term "qualified dividend income" means dividends received during the taxable year from—

(I) domestic corporations, and

(II) qualified foreign corporations.

(ii) Certain dividends excluded—Such term shall not include—

(I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,

(II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and

(III) any dividend described in section 404(k).

(iii) Coordination with section 246(c) Such term shall not include any dividend on any share of stock—

(I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by

substituting “121-day period” for “91-day period”), or

(II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(C) Qualified foreign corporations—

(i) In general—Except as otherwise provided in this paragraph, the term “qualified foreign corporation” means any foreign corporation if—

(I) such corporation is incorporated in a possession of the United States, or

(II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.

(ii) Dividends on stock readily tradable on United States securities market—A foreign corporation not otherwise treated as a qualified foreign corporation under clause (i) shall be so treated with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.

(iii) Exclusion of dividends of certain foreign corporations—Such term shall not include—

(I) any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297), and

(II) any corporation which first becomes a surrogate foreign corporation (as defined in section 7874(a)(2)(B)) after the date of the enactment of this subclause, other than a foreign corporation which is treated as a domestic corporation under section 7874(b).

(iv) Coordination with foreign tax credit limitation—Rules similar to the rules of section 904(b)(2)(B) shall apply with respect to the dividend rate differential under this paragraph.

(D) Special rules—

(i) Amounts taken into account as investment income—Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B).

(ii) Extraordinary dividends—If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) Treatment of dividends from regulated investment companies and real estate investment trusts—A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

(j) Modifications for taxable years beginning after 2017

(1) In general—In the case of a taxable year beginning after December 31, 2017—

(A) subsection (i) shall not apply, and

(B) this section (other than subsection (i)) shall be applied as provided in paragraphs (2) through (6).

(2) Rate tables—

(A) Married individuals filing joint returns and surviving spouses—The following table shall be applied in lieu of the table contained in subsection (a):

If taxable income is:	**The tax is:**
Not over $19,050	10% of taxable income.
Over $19,050 but not over $77,400	$1,905, plus 12% of the excess over $19,050.
Over $77,400 but not over $165,000	$8,907, plus 22% of the excess over $77,400.
Over $165,000 but not over $315,000	$28,179, plus 24% of the excess over $165,000.
Over $315,000 but not over $400,000	$64,179, plus 32% of the excess over $315,000.
Over $400,000 but not over $600,000	$91,379, plus 35% of the excess over $400,000.
Over $600,000	$161,379, plus 37% of the excess over $600,000.

(B) Heads of households—The following table shall be applied in lieu of the table contained in subsection (b):

If taxable income is:	**The tax is:**

Not over $13,600	10% of taxable income.
Over $13,600 but not over $51,800	$1,360, plus 12% of the excess over $13,600.
Over $51,800 but not over $82,500	$5,944, plus 22% of the excess over $51,800.
Over $82,500 but not over $157,500	$12,698, plus 24% of the excess over $82,500.
Over $157,500 but not over $200,000	$30,698, plus 32% of the excess over $157,500.
Over $200,000 but not over $500,000	$44,298, plus 35% of the excess over $200,000.
Over $500,000	$149,298, plus 37% of the excess over $500,000.

(C) Unmarried individuals other than surviving spouses and heads of households—The following table shall be applied in lieu of the table contained in subsection (c):

If taxable income is:	**The tax is:**
Not over $9,525	10% of taxable income.
Over $9,525 but not over $38,700	$952.50, plus 12% of the excess over $9,525.

Over $38,700 but not over $82,500	$4,453.50, plus 22% of the excess over $38,700.
Over $82,500 but not over $157,500	$14,089.50, plus 24% of the excess over $82,500.
Over $157,500 but not over $200,000	$32,089.50, plus 32% of the excess over $157,500.
Over $200,000 but not over $500,000	$45,689.50, plus 35% of the excess over $200,000.
Over $500,000	$150,689.50, plus 37% of the excess over $500,000.

(D) Married individuals filing separate returns—The following table shall be applied in lieu of the table contained in subsection (d):

If taxable income is:	**The tax is:**
Not over $9,525	10% of taxable income.
Over $9,525 but not over $38,700	$952.50, plus 12% of the excess over $9,525.
Over $38,700 but not over $82,500	$4,453.50, plus 22% of the excess over $38,700.
Over $82,500 but not over $157,500	$14,089.50, plus 24% of the excess over $82,500.

Over $157,500 but not over $200,000	$32,089.50, plus 32% of the excess over $157,500.
Over $200,000 but not over $300,000	$45,689.50, plus 35% of the excess over $200,000.
Over $300,000	$80,689.50, plus 37% of the excess over $300,000.

(E) Estates and trusts—The following table shall be applied in lieu of the table contained in subsection (e):

If taxable income is:	**The tax is:**
Not over $2,550	10% of taxable income.
Over $2,550 but not over $9,150	$255, plus 24% of the excess over $2,550.
Over $9,150 but not over $12,500	$1,839, plus 35% of the excess over $9,150.
Over $12,500	$3,011.50, plus 37% of the excess over $12,500.

(F) References to rate tables—Any reference in this title to a rate of tax under subsection (c) shall be treated as a reference to the corresponding rate bracket under subparagraph (C) of this paragraph, except that the reference in section 3402(q)(1) to the third lowest rate of tax applicable under subsection (c) shall be treated as a reference to the fourth lowest rate of tax under subparagraph (C).

(3) Adjustments—

(A) No adjustment in 2018—The tables contained in paragraph (2) shall apply without adjustment for taxable years beginning after December 31, 2017, and before January 1, 2019.

(B) Subsequent years—For taxable years beginning after December 31, 2018, the Secretary shall prescribe tables which shall apply in lieu of the tables contained in paragraph (2) in the same manner as under

paragraphs (1) and (2) of subsection (f) (applied without regard to clauses (i) and (ii) of subsection (f)(2)(A)), except that in prescribing such tables—

(i) solely for purposes of determining the dollar amounts at which any rate bracket higher than 12 percent ends and at which any rate bracket higher than 22 percent begins, subsection (f)(3) shall be applied by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof,

(ii) subsection (f)(7)(B) shall apply to any unmarried individual other than a surviving spouse or head of household, and

(iii) subsection (f)(8) shall not apply.

[(4) Repealed. Pub. L. 116–94, div. O, title V, §501(a), Dec. 20, 2019, 133 Stat. 3180]—

(5) Application of current income tax brackets to capital gains brackets—

(A) In general—Section 1(h)(1) shall be applied—

(i) by substituting "below the maximum zero rate amount" for "which would (without regard to this paragraph) be taxed at a rate below 25 percent" in subparagraph (B)(i), and

(ii) by substituting "below the maximum 15-percent rate amount" for "which would (without regard to this paragraph) be taxed at a rate below 39.6 percent" in subparagraph (C)(ii)(I).

(B) Maximum amounts defined—For purposes of applying section 1(h) with the modifications described in subparagraph (A)—

(i) Maximum zero rate amount—The maximum zero rate amount shall be—

(I) in the case of a joint return or surviving spouse, $77,200,

(II) in the case of an individual who is a head of household (as defined in section 2(b)), $51,700,

(III) in the case of any other individual (other than an estate or trust), an amount equal to ½ of the amount in effect for the taxable year under subclause (I), and

(IV) in the case of an estate or trust, $2,600.

(ii) Maximum 15-percent rate amount—The maximum 15-percent rate amount shall be—

(I) in the case of a joint return or surviving spouse, $479,000 (½ such amount in the case of a married individual filing a separate return),

(II) in the case of an individual who is the head of a household (as defined in section 2(b)), $452,400,

(III) in the case of any other individual (other than an estate or trust), $425,800, and

(IV) in the case of an estate or trust, $12,700.

(C) Inflation adjustment—In the case of any taxable year beginning after 2018, each of the dollar amounts in clauses (i) and (ii) of subparagraph (B) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under subsection (f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in

subparagraph (A)(ii) thereof.

If any increase under this subparagraph is not a multiple of $50, such increase shall be rounded to the next lowest multiple of $50.

(6) Section 15 not to apply—Section 15 shall not apply to any change in a rate of tax by reason of this subsection.

§11. TAX IMPOSED

(a) Corporations in general
A tax is hereby imposed for each taxable year on the taxable income of every corporation.

(b) Amount of tax
The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income.

§55. ALTERNATIVE MINIMUM TAX IMPOSED

(b) Tentative minimum tax

For purposes of this part—

(1) Noncorporate taxpayers—In the case of a taxpayer other than a corporation—

(A) In general—The tentative minimum tax for the taxable year is the sum of—

(i) 26 percent of so much of the taxable excess as does not exceed $175,000, plus

(ii) 28 percent of so much of the taxable excess as exceeds $175,000.

The amount determined under the preceding sentence shall be reduced by the alternative minimum tax foreign tax credit for the taxable year.

(B) Taxable excess—For purposes of this subsection, the term "taxable excess" means so much of the alternative minimum taxable income for the taxable year as exceeds the exemption amount.

(C) Married individual filing separate return—In the case of a married individual filing a separate return, subparagraph (A) shall be applied by substituting 50 percent of the dollar amount otherwise applicable under clause (i) and clause (ii) thereof. For purposes of the preceding sentence, marital status shall be determined under section 7703.

(D) Alternative minimum taxable income—The term "alternative minimum taxable income" means the taxable income of the taxpayer for the taxable year—

(i) determined with the adjustments provided in section 56 and section 58, and

(ii) increased by the amount of the items of tax preference described in section 57.

If a taxpayer is subject to the regular tax, such taxpayer shall be subject to the tax imposed by this section (and, if the regular tax is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of the preceding sentence).

(2) Corporations—

(A) Applicable corporations—In the case of an applicable corporation, the tentative minimum tax for the taxable year shall be the excess of—

(i) 15 percent of the adjusted financial statement income for the taxable year (as determined under section 56A), over

(ii) the corporate AMT foreign tax credit for the taxable year.

(B) Other corporations—In the case of any corporation which is not an applicable corporation, the tentative minimum tax for the taxable year shall be zero.

(3) Maximum rate of tax on net capital gain of noncorporate taxpayers—The amount determined under the first sentence of paragraph (1)(A) shall not exceed the sum of—

(A) the amount determined under such first sentence computed at the rates and in the same manner as if this paragraph had not been enacted on the taxable excess reduced by the lesser of—

(i) the net capital gain; or

(ii) the sum of—

(I) the adjusted net capital gain, plus

(II) the unrecaptured section 1250 gain, plus

(B) 0 percent of so much of the adjusted net capital gain (or, if less, taxable excess) as does not exceed an amount equal to the excess described in section 1(h)(1)(B), plus

(C) 15 percent of the lesser of—

(i) so much of the adjusted net capital gain (or, if less, taxable excess) as exceeds the amount on which tax is determined under subparagraph (B), or

(ii) the excess described in section 1(h)(1)(C)(ii), plus

(D) 20 percent of the adjusted net capital gain (or, if less, taxable excess) in excess of the sum of the amounts on which tax is determined under subparagraphs (B) and (C), plus

(E) 25 percent of the amount of taxable excess in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

Terms used in this paragraph which are also used in section 1(h) shall have the respective meanings given such terms by section 1(h) but computed with the adjustments under this part.

§56A. ADJUSTED FINANCIAL STATEMENT INCOME

(a) In general

For purposes of this part, the term “adjusted financial statement income” means, with respect to any corporation for any taxable year, the net income or loss of the taxpayer set forth on the taxpayer’s applicable financial statement for such taxable year, adjusted as provided in this section.

(b) Applicable financial statement

For purposes of this section, the term "applicable financial statement" means, with respect to any taxable year, an applicable financial statement (as defined in section 451(b)(3) or as specified by the Secretary in regulations or other guidance) which covers such taxable year.

(c) General adjustments

(1) Statements covering different taxable years—Appropriate adjustments shall be made in adjusted financial statement income in any case in which an applicable financial statement covers a period other than the taxable year.

(2) Special rules for related entities—

(A) Consolidated financial statements—If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, rules similar to the rules of section 451(b)(5) shall apply.

(B) Consolidated returns—Except as provided in regulations prescribed by the Secretary, if the taxpayer is part of an affiliated group of corporations filing a consolidated return for any taxable year, adjusted financial statement income for such group for such taxable year shall take into account items on the group's applicable financial statement which are properly allocable to members of such group.

(C) Treatment of dividends and other amounts—In the case of any corporation which is not included on a consolidated return with the taxpayer, adjusted financial statement income of the taxpayer with respect to such other corporation shall be determined by only taking into account the dividends received from such other corporation (reduced to the extent provided by the Secretary in regulations or other guidance) and other amounts which are includible in gross income or deductible as a loss under this chapter (other than amounts required to be included under sections 951 and 951A or such other amounts as provided by the Secretary) with respect to such other corporation.

(D) Treatment of partnerships—

(i) In general—Except as provided by the Secretary, if the taxpayer is a partner in a partnership, adjusted financial statement income of the taxpayer with respect to such partnership shall be adjusted to only take into account the taxpayer's distributive share of adjusted financial statement income of such partnership.

(ii) Adjusted financial statement income of partnerships—For the purposes of this part, the adjusted financial statement income of a partnership shall be the partnership's net income or loss set forth on such partnership's applicable financial statement (adjusted under rules similar to the rules of this section).

(3) Adjustments to take into account certain items of foreign income—

(A) In general—If, for any taxable year, a taxpayer is a United States shareholder of one or more controlled foreign corporations, the adjusted financial statement income of such taxpayer with respect to such controlled foreign corporation (as determined under paragraph (2)(C)) shall be adjusted to also take into account such taxpayer's pro rata share (determined under rules similar to the rules under section 951(a)(2)) of items taken into account in computing the net income or loss set forth on the applicable financial statement (as adjusted under rules similar to those that apply in determining adjusted financial statement income) of each such controlled foreign corporation with respect to which such taxpayer is a United States shareholder.

(B) Negative adjustments—In any case in which the adjustment determined under subparagraph (A) would result in a negative adjustment for such taxable year—

(i) no adjustment shall be made under this paragraph for such taxable year, and

(ii) the amount of the adjustment determined under this paragraph for the succeeding taxable year (determined without regard to this paragraph) shall be reduced by an amount equal to the negative adjustment for such taxable year.

(4) Effectively connected income—In the case of a foreign corporation, to determine adjusted financial statement income, the principles of section 882 shall apply.

(5) Adjustments for certain taxes—Adjusted financial statement income shall be appropriately adjusted to disregard any Federal income taxes, or income, war profits, or excess profits taxes (within the meaning of section 901) with respect to a foreign country or possession of the United States, which are taken into account on the taxpayer's applicable financial statement. To the extent provided by the Secretary, the preceding sentence shall not apply to income, war profits, or excess profits taxes (within the meaning of section 901) that are imposed by a foreign country or possession of the United States and taken into account on the taxpayer's applicable financial statement if the taxpayer does not choose to have the benefits of subpart A of part III of subchapter N for the taxable year. The Secretary shall prescribe such regulations or other guidance as may be necessary and appropriate to provide for the proper treatment of current and deferred taxes for purposes of this paragraph, including the time at which such taxes are properly taken into account.

(6) Adjustment with respect to disregarded entities—Adjusted financial statement income shall be adjusted to take into account any adjusted financial statement income of a disregarded entity owned by the taxpayer.

(7) Special rule for cooperatives—In the case of a cooperative to which section 1381 applies, the adjusted financial statement income (determined without regard to this paragraph) shall be reduced by the amounts referred to in section 1382(b) (relating to patronage dividends and per-unit retain allocations) to the extent such amounts were not otherwise taken into account in determining adjusted financial statement income.

(8) Rules for Alaska native corporations—Adjusted financial statement income shall be appropriately adjusted to allow—

(A) cost recovery and depletion attributable to property the basis of which is determined under section 21(c) of the Alaska Native Claims Settlement Act (43 U.S.C. 1620(c)), and

(B) deductions for amounts payable made pursuant to section 7(i) or section 7(j) of such Act (43 U.S.C. 1606(i) and 1606(j)) only at such time as the deductions are allowed for tax purposes.

(9) Amounts attributable to elections for direct payment of certain credits—Adjusted financial statement income shall be appropriately adjusted to disregard any amount treated as a payment against the tax imposed by subtitle A pursuant to an election under section 48D(d) or 6417, to the extent such amount was not otherwise taken into account under paragraph (5).

(10) Consistent treatment of mortgage servicing income of taxpayer other than a regulated investment company—

(A) In general—Adjusted financial statement income shall be adjusted so as not to include any item of income in connection with a mortgage servicing contract any earlier than when such income is included in gross income under any other provision of this chapter.

(B) Rules for amounts not representing reasonable compensation—The Secretary shall provide regulations to prevent the avoidance of taxes imposed by this chapter with respect to amounts not representing reasonable compensation (as determined by the Secretary) with respect to a mortgage servicing contract.

(11) Adjustment with respect to defined benefit pensions—

(A) In general—Except as otherwise provided in rules prescribed by the Secretary in regulations or other guidance, adjusted financial statement income shall be—

(i) adjusted to disregard any amount of income, cost, or expense that would otherwise be included on the applicable financial statement in connection with any covered benefit plan,

(ii) increased by any amount of income in connection with any such covered benefit plan that is included in the gross income of the corporation under any other provision of this chapter, and

(iii) reduced by deductions allowed under any other provision of this chapter with respect to any such covered benefit plan.

(B) Covered benefit plan—For purposes of this paragraph, the term "covered benefit plan" means—

(i) a defined benefit plan (other than a multiemployer plan described in section 414(f)) if the trust which is part of such plan is an employees' trust described in section 401(a) which is exempt from tax under section 501(a),

(ii) any qualified foreign plan (as defined in section 404A(e)), or

(iii) any other defined benefit plan which provides post-employment benefits other than pension benefits.

(12) Tax-exempt entities—In the case of an organization subject to tax under section 511, adjusted financial statement income shall be appropriately adjusted to only take into account any adjusted financial statement income—

(A) of an unrelated trade or business (as defined in section 513) of such organization, or

(B) derived from debt-financed property (as defined in section 514) to the extent that income from such property is treated as unrelated business taxable income.

(13) Depreciation—Adjusted financial statement income shall be—

(A) reduced by—

(i) depreciation deductions allowed under section 167 with respect to property to which section 168 applies to the extent of the amount allowed as deductions in computing taxable income for the year, and

(ii) any deduction allowed for expenses under section 263(c) (including any deduction for such expenses under section 59(e) or 291(b)(2)) with respect to property described therein to the extent of the amount allowed as deductions in computing taxable income for the year, and

(B) appropriately adjusted—

(i) to disregard any amount of—

(I) depreciation expense that is taken into account on the taxpayer's applicable financial statement with respect to such property, and

(II) depletion expense that is taken into account on the taxpayer's applicable financial statement with respect to the intangible drilling and development costs of such property, and

(ii) to take into account any other item specified by the Secretary in order to provide that such property is accounted for in the same manner as it is accounted for under this chapter.

(14) Qualified wireless spectrum—

(A) In general—Adjusted financial statement income shall be—

(i) reduced by amortization deductions allowed under section 197 with respect to qualified wireless spectrum to the extent of the amount allowed as deductions in computing taxable income for the taxable year, and

(ii) appropriately adjusted—

(I) to disregard any amount of amortization expense that is taken into account on the taxpayer's applicable financial statement with respect to such qualified wireless spectrum, and

(II) to take into account any other item specified by the Secretary in order to provide that such qualified wireless spectrum is accounted for in the same manner as it is accounted for under this chapter.

(B) Qualified wireless spectrum—For purposes of this paragraph, the term "qualified wireless spectrum" means wireless spectrum which—

(i) is used in the trade or business of a wireless telecommunications carrier, and

(ii) was acquired after December 31, 2007, and before the date of enactment of this section.

(15) Secretarial authority to adjust items—The Secretary shall issue regulations or other guidance to provide for such adjustments to adjusted financial statement income as the Secretary determines necessary to carry out the purposes of this section, including adjustments—

(A) to prevent the omission or duplication of any item, and

(B) to carry out the principles of part II of subchapter C of this chapter (relating to corporate liquidations), part III of subchapter C of this chapter (relating to corporate organizations and reorganizations), and part II of subchapter K of this chapter (relating to partnership contributions and distributions).

(d) Deduction for financial statement net operating loss

(1) In general—Adjusted financial statement income (determined after application of subsection (c) and without regard to this subsection) shall be reduced by an amount equal to the lesser of—

(A) the aggregate amount of financial statement net operating loss carryovers to the taxable year, or

(B) 80 percent of adjusted financial statement income computed without regard to the deduction allowable under this subsection.

(2) Financial statement net operating loss carryover—A financial statement net operating loss for any taxable year shall be a financial statement net operating loss carryover to each taxable year following the taxable year of the loss. The portion of such loss which shall be carried to subsequent taxable years shall be the amount of such loss remaining (if any) after the application of paragraph (1).

(3) Financial statement net operating loss defined—For purposes of this subsection, the term "financial statement net operating loss" means the amount of the net loss (if any) set forth on the corporation's applicable financial statement (determined after application of subsection (c) and without regard to this subsection) for taxable years ending after December 31, 2019.

(e) Regulations and other guidance

The Secretary shall provide for such regulations and other guidance as necessary to carry out the purposes of this section, including regulations and other guidance relating to the effect of the rules of this section on partnerships with income taken into account by an applicable corporation.

§59. OTHER DEFINITIONS AND SPECIAL RULES

(k) Applicable corporation

For purposes of this part—

(1) Applicable corporation defined—

(A) In general—The term "applicable corporation" means, with respect to any taxable year, any corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) which meets the average annual adjusted financial statement income test of subparagraph (B) for one or more taxable years which—

(i) are prior to such taxable year, and

(ii) end after December 31, 2021.

(B) Average annual adjusted financial statement income test—For purposes of this subsection—

(i) a corporation meets the average annual adjusted financial statement income test for a taxable year if the average annual adjusted financial statement income of such corporation (determined without regard to section 56A(d)) for the 3-taxable-year period ending with such taxable year exceeds $1,000,000,000, and

(ii) in the case of a corporation described in paragraph (2), such corporation meets the average annual adjusted financial statement income test for a taxable year if—

(I) the corporation meets the requirements of clause (i) for such taxable year (determined after the application of paragraph (2)), and

(II) the average annual adjusted financial statement income of such corporation (determined without regard to the application of paragraph (2) and without regard to section 56A(d)) for the 3-taxable-year-period ending with such taxable year is $100,000,000 or more.

(C) Exception—Notwithstanding subparagraph (A), the term "applicable corporation" shall not include any corporation which otherwise meets the requirements of subparagraph (A) if—

(i) such corporation—

(I) has a change in ownership, or

(II) has a specified number (to be determined by the Secretary and which shall, as appropriate, take into account the facts and circumstances of the taxpayer) of consecutive taxable years, including the most recent taxable year, in which the corporation does not meet the average annual adjusted financial statement income test of subparagraph (B), and

(ii) the Secretary determines that it would not be appropriate to continue to treat such corporation as an applicable corporation.

The preceding sentence shall not apply to any corporation if, after the Secretary makes the determination described in clause (ii), such corporation meets the average annual adjusted financial statement income test of subparagraph (B) for any taxable year beginning after the first taxable year for which such determination applies.

(D) Special rules for determining applicable corporation status—Solely for purposes of determining whether a corporation is an applicable corporation under this paragraph, all adjusted financial statement income of persons treated as a single employer with such corporation under subsection (a) or (b) of section 52 shall be treated as adjusted financial statement income of such corporation, and adjusted financial statement income of such corporation shall be determined without regard to paragraphs (2)(D)(i) and (11) of section 56A(c).

(E) Other special rules—

(i) Corporations in existence for less than 3 years—If the corporation was in existence for less than 3-taxable years, subparagraph (B) shall be applied on the basis of the period during which such corporation was in existence.

(ii) Short taxable years—Adjusted financial statement income for any taxable year of less than 12 months shall be annualized by multiplying the adjusted financial statement income for the short period by 12 and dividing the result by the number of months in the short period.

(iii) Treatment of predecessors—Any reference in this subparagraph to a corporation shall include a reference to any predecessor of such corporation.

(2) Special rule for foreign-parented multinational groups—

(A) In general—If a corporation is a member of a foreign-parented multinational group for any taxable year, then, solely for purposes of determining whether such corporation meets the average annual adjusted financial statement income test under paragraph (1)(B)(ii)(I) for such taxable year, the adjusted financial statement income of such corporation for such taxable year shall include the adjusted financial statement income of all members of such group. Solely for purposes of this subparagraph, adjusted financial statement income shall be determined without regard to paragraphs (2)(D)(i), (3), (4), and (11) of section 56A(c).

(B) Foreign-parented multinational group—For purposes of subparagraph (A), the term "foreign-parented multinational group" means, with respect to any taxable year, two or more entities if—

(i) at least one entity is a domestic corporation and another entity is a foreign corporation,

(ii) such entities are included in the same applicable financial statement with respect to such year, and

(iii) either—

(I) the common parent of such entities is a foreign corporation, or

(II) if there is no common parent, the entities are treated as having a common parent which is a foreign corporation under subparagraph (D).

(C) Foreign corporations engaged in a trade or business within the United States—For purposes of this paragraph, if a foreign corporation is engaged in a trade or business within the United States, such trade or business shall be treated as a separate domestic corporation that is wholly owned by the foreign corporation.

(D) Other rules—The Secretary shall, applying the principles of this section, prescribe rules for the application of this paragraph, including rules for the determination of—

(i) the entities (if any) which are to be to be treated under subparagraph (B)(iii)(II) as having a common parent which is a foreign corporation,

(ii) the entities to be included in a foreign-parented multinational group, and

(iii) the common parent of a foreign-parented multinational group.

(3) Regulations or other guidance—The Secretary shall provide regulations or other guidance for the purposes of carrying out this subsection, including regulations or other guidance—

(A) providing a simplified method for determining whether a corporation meets the requirements of paragraph (1), and'(B)1 addressing the application of this subsection to a corporation that experiences a change in ownership.

§61. GROSS INCOME DEFINED

(a) General definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Annuities;

(9) Income from life insurance and endowment contracts;

(10) Pensions;

(11) Income from discharge of indebtedness;

(12) Distributive share of partnership gross income;

(13) Income in respect of a decedent; and

(14) Income from an interest in an estate or trust.

§83. PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES

(a) General rule

If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

(h) Deduction by employer

In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

§118. CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION

(a) General rule

In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Exceptions

For purposes of subsection (a), except as provided in subsection (c), the term "contribution to the capital of the taxpayer" does not include—

(1) any contribution in aid of construction or any other contribution as a customer or potential customer, and

(2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

(c) Special rules for water and sewerage disposal utilities

(1) General rule—For purposes of this section, the term "contribution to the capital of the taxpayer" includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewerage disposal services if—

(A) such amount is—

(i) a contribution in aid of construction, or

(ii) a contribution to the capital of such utility by a governmental entity providing for the protection, preservation, or enhancement of drinking water or sewerage disposal services,

(B) in the case of a contribution in aid of construction which is property other than water or sewerage disposal facilities, such amount meets the requirements of the expenditure rule of paragraph (2), and

(C) such amount (or any property acquired or constructed with such amount) is not included in the taxpayer's rate base for ratemaking purposes.

(2) Expenditure rule—An amount meets the requirements of this paragraph if—

(A) an amount equal to such amount is expended for the acquisition or construction of tangible property described in section 1231(b)—

(i) which is the property for which the contribution was made or is of the same type as such property, and

(ii) which is used predominantly in the trade or business of furnishing water or sewerage disposal services,

(B) the expenditure referred to in subparagraph (A) occurs before the end of the second taxable year after the year in which such amount was received, and

(C) accurate records are kept of the amounts contributed and expenditures made, the expenditures to which contributions are allocated, and the year in which the contributions and expenditures are received and made.

(3) Definitions—For purposes of this subsection—

(A) Contribution in aid of construction—The term "contribution in aid of construction" shall be defined by regulations prescribed by the Secretary, except that such term shall not include amounts paid as service charges for starting or stopping services.

(B) Predominantly—The term "predominantly" means 80 percent or more.

(C) Regulated public utility—The term "regulated public utility" has the meaning given such term by section 7701(a)(33), except that such term shall not include any utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(4) Disallowance of deductions and credits; adjusted basis—Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, any expenditure which constitutes a contribution in aid of construction to which this subsection applies. The adjusted basis of any property acquired with contributions in aid of construction to which this subsection applies shall be zero.

(d) Statute of limitations

If the taxpayer for any taxable year treats an amount as a contribution to the capital of the taxpayer described in subsection (c)(1)(A)(i), then—

(1) the statutory period for the assessment of any deficiency attributable to any part of such amount shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of—

(A) the amount of the expenditure referred to in subparagraph (A) of subsection (c)(2),

(B) the taxpayer's intention not to make the expenditures referred to in such subparagraph, or

(C) a failure to make such expenditure within the period described in subparagraph (B) of subsection (c)(2), and

(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(e) Cross references

(1) For basis of property acquired by a corporation through a contribution to its capital, see section 362.

(2) For special rules in the case of contributions of indebtedness, see section 108(e)(6).

§163. INTEREST

(j) Limitation on business interest

(1) In general—The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of—

(A) the business interest income of such taxpayer for such taxable year,

(B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus

(C) the floor plan financing interest of such taxpayer for such taxable year.

The amount determined under subparagraph (B) shall not be less than zero.

(2) Carryforward of disallowed business interest—The amount of any business interest not allowed as a deduction for any taxable year by reason of paragraph (1) shall be treated as business interest paid or accrued in the succeeding taxable year.

(3) Exemption for certain small businesses—In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year. In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.

(4) Application to partnerships, etc.—

(A) In general—In the case of any partnership—

(i) this subsection shall be applied at the partnership level and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership, and

(ii) the adjusted taxable income of each partner of such partnership—

(I) shall be determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and

(II) shall be increased by such partner's distributive share of such partnership's excess taxable income.

For purposes of clause (ii)(II), a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership.

(B) Special rules for carryforwards—

(i) In general—The amount of any business interest not allowed as a deduction to a partnership for any taxable year by reason of paragraph (1) for any taxable year—

(I) shall not be treated under paragraph (2) as business interest paid or accrued by the partnership in the succeeding taxable year, and

(II) shall, subject to clause (ii), be treated as excess business interest which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

(ii) Treatment of excess business interest allocated to partners—If a partner is allocated any excess business interest from a partnership under clause (i) for any taxable year—

(I) such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and

(II) any portion of such excess business interest remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest paid or accrued in succeeding taxable years.

For purposes of applying this paragraph, excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph (1)(A) with respect to any business interest other than excess business interest from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued under clause (ii).

(iii) Basis adjustments—

(I) In general—The adjusted basis of a partner in a partnership interest shall be reduced (but not below zero) by the amount of excess business interest allocated to the partner under clause (i)(II).

(II) Special rule for dispositions—If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest shall be increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under subclause (I) over the portion of any excess business interest allocated to the partner under clause (i)(II) which has previously been treated under clause (ii) as business interest paid or accrued by the partner. The preceding sentence shall also apply to transfers of the partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction shall be allowed to the transferor or transferee under this chapter for any excess business interest resulting

in a basis increase under this subclause.

(C) Excess taxable income—The term "excess taxable income" means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as—

(i) the excess (if any) of—

(I) the amount determined for the partnership under paragraph (1)(B), over

(II) the amount (if any) by which the business interest of the partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership, bears to

(ii) the amount determined for the partnership under paragraph (1)(B).

(D) Application to S corporations—Rules similar to the rules of subparagraphs (A) and (C) shall apply with respect to any S corporation and its shareholders.

(5) Business interest—For purposes of this subsection, the term "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term shall not include investment interest (within the meaning of subsection (d)). Such term shall not include any interest which is capitalized under section 263(g) or 263A(f).

(6) Business interest income—For purposes of this subsection, the term "business interest income" means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Such term shall not include investment income (within the meaning of subsection (d)).

(7) Trade or business—For purposes of this subsection—

(A) In general—The term "trade or business" shall not include—

(i) the trade or business of performing services as an employee,

(ii) any electing real property trade or business,

(iii) any electing farming business, or

(iv) the trade or business of the furnishing or sale of—

(I) electrical energy, water, or sewage disposal services,

(II) gas or steam through a local distribution system, or

(III) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

(B) Electing real property trade or business—For purposes of this paragraph, the term "electing real property trade or business" means any trade or business which is described in section 469(c)(7)(C) and which makes an election under this subparagraph. Any such election shall be made at such time and in such manner as the Secretary shall prescribe, and, once made, shall be irrevocable.

(C) Electing farming business—For purposes of this paragraph, the term "electing farming business" means—

(i) a farming business (as defined in section 263A(e)(4)) which makes an election under this subparagraph, or

(ii) any trade or business of a specified agricultural or horticultural cooperative (as defined in section 199A(g)(2))1 with respect to which the cooperative makes an election under this subparagraph.

Any such election shall be made at such time and in such manner as the Secretary shall prescribe, and, once made, shall be irrevocable.

(8) Adjusted taxable income—For purposes of this subsection, the term "adjusted taxable income" means the taxable income of the taxpayer—

(A) computed without regard to—

(i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,

(ii) any business interest or business interest income,

(iii) the amount of any net operating loss deduction under section 172,

(iv) the amount of any deduction allowed under section 199A,

(v) any deduction allowable for depreciation, amortization, or depletion, and

(vi) the amounts included in gross income under sections 951(a), 951A(a), and 78 (and the portion of the deductions allowed under sections 245A(a) (by reason of section 964(e)(4)) and 250(a)(1)(B) by reason of such inclusions), and

(B) computed with such other adjustments as provided by the Secretary.

(9) Floor plan financing interest defined—For purposes of this subsection—

(A) In general—The term "floor plan financing interest" means interest paid or accrued on floor plan financing indebtedness.

(B) Floor plan financing indebtedness—The term "floor plan financing indebtedness" means indebtedness—

(i) used to finance the acquisition of motor vehicles held for sale or lease, and

(ii) secured by the inventory so acquired.

(C) Motor vehicle—The term "motor vehicle" means a motor vehicle that is any of the following:

(i) Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.

(ii) A boat.

(iii) Farm machinery or equipment.

Such term shall also include any trailer or camper which is designed to provide temporary living quarters for recreational, camping, or seasonal use and is designed to be towed by, or affixed to, a motor vehicle.

(10) Coordination with interest capitalization provisions—

(A) In general—In applying this subsection—

(i) the limitation under paragraph (1) shall apply to business interest without regard to whether the taxpayer would otherwise deduct such business interest or capitalize such business interest under an interest capitalization provision, and

(ii) any reference in this subsection to a deduction for business interest shall be treated as including a reference to the capitalization of business interest.

(B) Amount allowed applied first to capitalized interest—The amount allowed after taking into account the limitation described in paragraph (1)—

(i) shall be applied first to the aggregate amount of business interest which would otherwise be capitalized, and

(ii) the remainder (if any) shall be applied to the aggregate amount of business interest which would be deducted.

(C) Treatment of disallowed interest carried forward—No portion of any business interest carried forward under paragraph (2) from any taxable year to any succeeding taxable year shall, for purposes of this title (including any interest capitalization provision which previously applied to such portion) be treated as interest to which an interest capitalization provision applies.

(D) Interest capitalization provision—For purposes of this section, the term "interest capitalization provision" means any provision of this subtitle under which interest—

(i) is required to be charged to capital account, or

(ii) may be deducted or charged to capital account.

(11) Regulatory authority—The Secretary shall issue such regulations or guidance as may be necessary or appropriate to carry out the purposes of this subsection, including regulations or guidance to determine which business interest is taken into account under this subsection and section 59A(c)(3).

(12) Special rule for taxable years beginning in 2019 and 2020—

(A) In general—

(i) In general—Except as provided in clause (ii) or (iii), in the case of any taxable year beginning in 2019 or 2020, paragraph (1)(B) shall be applied by substituting "50 percent" for "30 percent".

(ii) Special rule for partnerships—In the case of a partnership—

(I) clause (i) shall not apply to any taxable year beginning in 2019, but

(II) unless a partner elects not to have this subclause apply, in the case of any excess business interest of the partnership for any taxable year beginning in 2019 which is allocated to the partner under paragraph (4)(B)(i)(II)—**(aa)** 50 percent of such excess business interest shall be treated as business interest which, notwithstanding paragraph (4)(B)(ii), is paid or accrued by the partner in

the partner's first taxable year beginning in 2020 and which is not subject to the limits of paragraph (1), and **(bb)** 50 percent of such excess business interest shall be subject to the limitations of paragraph (4)(B)(ii) in the same manner as any other excess business interest so allocated.

(iii) Election out—A taxpayer may elect, at such time and in such manner as the Secretary may prescribe, not to have clause (i) apply to any taxable year. Such an election, once made, may be revoked only with the consent of the Secretary. In the case of a partnership, any such election shall be made by the partnership and may be made only for taxable years beginning in 2020.

(B) Election to use 2019 adjusted taxable income for taxable years beginning in 2020—

(i) In general—Subject to clause (ii), in the case of any taxable year beginning in 2020, the taxpayer may elect to apply this subsection by substituting the adjusted taxable income of the taxpayer for the last taxable year beginning in 2019 for the adjusted taxable income for such taxable year. In the case of a partnership, any such election shall be made by the partnership.

(ii) Special rule for short taxable years—If an election is made under clause (i) for a taxable year which is a short taxable year, the adjusted taxable income for the taxpayer's last taxable year beginning in 2019 which is substituted under clause (i) shall be equal to the amount which bears the same ratio to such adjusted taxable income determined without regard to this clause as the number of months in the short taxable year bears to 122

(13) Cross references—

(A) For requirement that an electing real property trade or business use the alternative depreciation system, see section 168(g)(1)(F).

(B) For requirement that an electing farming business use the alternative depreciation system, see section 168(g)(1)(G).

§168. ACCELERATED COST RECOVERY SYSTEM

(k) Special allowance for certain property

(1) Additional allowance—In the case of any qualified property—

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to 100 percent of the adjusted basis of the qualified property, and

(B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

(2) Qualified property—For purposes of this subsection—

(A) In general—The term "qualified property" means property—

(i)

(I) to which this section applies which has a recovery period of 20 years or less,

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or2

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (h) of such section or this subsection,

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (h) of such section or this subsection, and or3

(VI) which is a qualified sound recording production (as defined in subsection (f) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (h) of such section or this subsection, and

(ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (i) of subparagraph (E).

(B) Certain property having longer production periods treated as qualified property—

(i) In general—The term "qualified property" includes any property if such property—

(I) meets the requirements of clauses (i) and (ii) of subparagraph (A),

(II) has a recovery period of at least 10 years or is transportation property,

(III) is subject to section 263A, and

(IV) meets the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applies to property which has a long useful life (within the meaning of section 263A(f))).

(ii) Transportation property—For purposes of this subparagraph, the term "transportation property" means tangible personal property used in the trade or business of transporting persons or property.

(iii) Application of subparagraph—This subparagraph shall not apply to any property which is described in subparagraph (C).

(C) Certain aircraft—The term "qualified property" includes property—

(i) which meets the requirements of subparagraph (A)(ii),

(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(ii)) other than for agricultural or firefighting purposes,

(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of—

(I) 10 percent of the cost, or

(II) $100,000, and

(iv) which has—

(I) an estimated production period exceeding 4 months, and

(II) a cost exceeding $200,000.

(D) Exception for alternative depreciation property—The term "qualified property" shall not include any property to which the alternative depreciation system under subsection (g) applies, determined—

(i) without regard to paragraph (7) of subsection (g) (relating to election to have system apply), and

(ii) after application of section 280F(b) (relating to listed property with limited business use).

(E) Special rules—

(i) Acquisition requirements—An acquisition of property meets the requirements of this clause if—

(I) such property was not used by the taxpayer at any time prior to such acquisition, and

(II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d).

(ii) Syndication—For purposes of subparagraph (A)(ii), if—

(I) property is used by a lessor of such property and such use is the lessor's first use of such property,

(II) such property is sold by such lessor or any subsequent purchaser within 3 months after the date such property was originally placed in service (or, in the case of multiple units of property subject to the same lease, within 3 months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months), and

(III) the user of such property after the last sale during such 3-month period remains the same as when such property was originally placed in service,

such property shall be treated as originally placed in service not earlier than the date of such last sale.

(F) Coordination with section 280F—For purposes of section 280F—

(i) Automobiles—In the case of a passenger automobile (as defined in section 280F(d)(5)) which is qualified property, the Secretary shall increase the limitation under section 280F(a)(1)(A)(i) by $8,000.

(ii) Listed property—The deduction allowable under paragraph (1) shall be taken into account in computing any recapture amount under section 280F(b)(2).

(iii) Phase down—In the case of a passenger automobile acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after September 27, 2017, clause (i) shall be applied by substituting for "$8,000"—

(I) in the case of an automobile placed in service during 2018, $6,400, and

(II) in the case of an automobile placed in service during 2019, $4,800.

(G) Deduction allowed in computing minimum tax—For purposes of determining alternative minimum taxable income under section 55, the deduction under section 167 for qualified property shall be determined without regard to any adjustment under section 56.

(H) Production placed in service—For purposes of subparagraph (A)—

(i) a qualified film or television production shall be considered to be placed in service at the time of initial release or broadcast,

(ii) a qualified live theatrical production shall be considered to be placed in service at the time of the initial live staged performance, and

(iii) a qualified sound recording production shall be considered to be placed in service at the time of initial release or broadcast.

[(3) Repealed. Pub. L. 115–97, title I, §13204(a)(4)(B)(ii), Dec. 22, 2017, 131 Stat. 2111]—

[(4) Repealed. Pub. L. 115–97, title I, §12001(b)(13), Dec. 22, 2017, 131 Stat. 2094]—

(5) Special rules for certain plants bearing fruits and nuts—

(A) In general—In the case of any specified plant which is planted or grafted by the taxpayer in the ordinary course of the taxpayer's farming business (as defined in section 263A(e)(4)) during a taxable year for which the taxpayer has elected the application of this paragraph—

(i) a depreciation deduction equal to 100 percent of the adjusted basis of such specified plant shall be allowed under section 167(a) for the taxable year in which such specified plant is so planted or grafted, and

(ii) the adjusted basis of such specified plant shall be reduced by the amount of such deduction.

(B) Specified plant—For purposes of this paragraph, the term "specified plant" means—

(i) any tree or vine which bears fruits or nuts, and

(ii) any other plant which will have more than one crop or yield of fruits or nuts and which generally has a pre-productive period of more than 2 years from the time of planting or grafting to the time at which such plant begins bearing a marketable crop or yield of fruits or nuts.

Such term shall not include any property which is planted or grafted outside of the United States.

(C) Election revocable only with consent—An election under this paragraph may be revoked only with the consent of the Secretary.

(D) Additional depreciation may be claimed only once—If this paragraph applies to any specified plant, such specified plant shall not be treated as qualified property in the taxable year in which placed in service.

(E) Deduction allowed in computing minimum tax—Rules similar to the rules of paragraph (2)(G) shall apply for purposes of this paragraph.

[(6)Repealed. Pub. L. 119–21, title VII, §70301(b)(1)(B), July 4, 2025, 139 Stat. 189]—

(7) Election out—If a taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, paragraphs (1) and (2)(F) shall not apply to any qualified property in such class placed in service during such taxable year. An election under this paragraph may be revoked only with the consent of the Secretary.

[(8) Repealed. Pub. L. 119–21, title VII, §70301(b)(1)(B), July 4, 2025, 139 Stat. 189]—

(9) Exception for certain property—The term "qualified property" shall not include—

(A) any property which is primarily used in a trade or business described in clause (iv) of section 163(j)(7)(A), or

(B) any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section.

(10) Special rule for property placed in service during certain periods—

(A) In general—In the case of qualified property placed in service by the taxpayer during the first taxable year ending after January 19, 2025, if the taxpayer elects to have this paragraph apply for such taxable year, paragraph (1)(A) shall be applied—

(i) in the case of property which is not described in clause (ii), by substituting "40 percent" for "100 percent", or

(ii) in the case of property which is described in subparagraph (B) or (C) of paragraph (2), by substituting "60 percent" for "100 percent".

(B) Specified plants—In the case of any specified plant planted or grafted by the taxpayer during the first taxable year ending after January 19, 2025, if the taxpayer elects to have this paragraph apply for such taxable year, paragraph (5)(A)(i) shall be applied by substituting "40 percent" for "100 percent".

(C) Form of election—Any election under this paragraph shall be made at such time and in such form and manner as the Secretary may prescribe.

§172. NET OPERATING LOSS DEDUCTION

(a) Deduction allowed

There shall be allowed as a deduction for the taxable year an amount equal to—

(1) in the case of a taxable year beginning before January 1, 2021, the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, and

(2) in the case of a taxable year beginning after December 31, 2020, the sum of—

(A) the aggregate amount of net operating losses arising in taxable years beginning before January 1, 2018, carried to such taxable year, plus

(B) the lesser of—

(i) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, carried to such taxable year, or

(ii) 80 percent of the excess (if any) of—

(I) taxable income computed without regard to the deductions under this section and sections 199A and 250, over

(II) the amount determined under subparagraph (A).

For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net operating loss carrybacks and carryovers

(1) Years to which loss may be carried—

(A) General rule—A net operating loss for any taxable year—

(i) shall be a net operating loss carryback to the extent provided in subparagraphs (B), (C)(i), and (D), and

(ii) except as provided in subparagraph (C)(ii), shall be a net operating loss carryover—

(I) in the case of a net operating loss arising in a taxable year beginning before January 1, 2018, to each of the 20 taxable years following the taxable year of the loss, and

(II) in the case of a net operating loss arising in a taxable year beginning after December 31, 2017, to each taxable year following the taxable year of the loss.

(B) Farming losses—

(i) In general—In the case of any portion of a net operating loss for the taxable year which is a farming loss with respect to the taxpayer, such loss shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss.

(ii) Farming loss—For purposes of this section, the term "farming loss" means the lesser of—

(I) the amount which would be the net operating loss for the taxable year if only income and deductions attributable to farming businesses (as defined in section 263A(e)(4)) are taken into account, or

(II) the amount of the net operating loss for such taxable year.

(iii) Coordination with paragraph (2) For purposes of applying paragraph (2), a farming loss for any taxable year shall be treated as a separate net operating loss for such taxable year to be taken into account after the remaining portion of the net operating loss for such taxable year.

(iv) Election—Any taxpayer entitled to a 2-year carryback under clause (i) from any loss year may elect not to have such clause apply to such loss year. Such election shall be made in such manner as prescribed by the Secretary and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

(C) Insurance companies—In the case of an insurance company (as defined in section 816(a)) other than a life insurance company, the net operating loss for any taxable year—

(i) shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(ii) shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss.

(D) Special rule for losses arising in 2018, 2019, and 2020—

(i) In general—In the case of any net operating loss arising in a taxable year beginning after December 31, 2017, and before January 1, 2021—

(I) such loss shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss, and

(II) subparagraphs (B) and (C)(i) shall not apply.

(ii) Special rules for REITs—For purposes of this subparagraph—

(I) In general—A net operating loss for a REIT year shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss.

(II) Special rule—In the case of any net operating loss for a taxable year which is not a REIT year, such loss shall not be carried to any preceding taxable year which is a REIT year.

(III) REIT year—For purposes of this subparagraph, the term "REIT year" means any taxable year for which the provisions of part II of subchapter M (relating to real estate investment trusts) apply to the taxpayer.

(iii) Special rule for life insurance companies— In the case of a life insurance company, if a net operating loss is carried pursuant to clause (i)(I) to a life insurance company taxable year beginning before January 1, 2018, such net operating loss carryback shall be treated in the same manner as an operations loss carryback (within the meaning of section 810 as in effect before its repeal) of such company to such taxable year.

(iv) Rule relating to carrybacks to years to which section 965 applies—If a net operating loss of a taxpayer is carried pursuant to clause (i)(I) to any taxable year in which an amount is includible in gross income by reason of section 965(a), the taxpayer shall be treated as having made the election under section 965(n) with respect to each such taxable year.

(v) Special rules for elections under paragraph (3)

(I) Special election to exclude section 965 years—If the 5-year carryback period under clause (i)(I) with respect to any net operating loss of a taxpayer includes 1 or more taxable years in which an amount is includible in gross income by reason of section 965(a), the taxpayer may, in lieu of the election otherwise available under paragraph (3), elect under such paragraph to exclude all such taxable years from such carryback period.

(II) Time of elections—An election under paragraph (3) (including an election described in subclause (I)) with respect to a net operating loss arising in a taxable year beginning in 2018 or 2019 shall be made by the due date (including extensions of time) for filing the taxpayer's return for the first taxable year ending after the date of the enactment of this subparagraph.

(2) Amount of carrybacks and carryovers—The entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall—

(A) be computed with the modifications specified in subsection (d) other than paragraphs (1), (4), and (5) thereof, and by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

(B) not be considered to be less than zero, and

(C) for taxable years beginning after December 31, 2020, be reduced by 20 percent of the excess (if any) described in subsection (a)(2)(B)(ii) for such taxable year.

(3) Election to waive carryback—Any taxpayer entitled to a carryback period under paragraph (1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year. Such election shall be made in such manner as may be prescribed by the Secretary, and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss for which the election is to be in effect. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

(c) Net operating loss defined

For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications

The modifications referred to in this section are as follows:

(1) Net operating loss deduction—No net operating loss deduction shall be allowed.

(2) Capital gains and losses of taxpayers other than corporations—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includable on account of gains from sales or exchanges of capital assets; and

(B) the exclusion provided by section 1202 shall not be allowed.

(3) Deduction for personal exemptions—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness deductions of taxpayers other than corporations—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;

(C) any deduction for casualty or theft losses allowable under paragraph (2) or (3) of section 165(c) shall be treated as attributable to the trade or business; and

(D) any deduction allowed under section 404 to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

(5) Computation of deduction for dividends received—The deductions allowed by sections 243 (relating to dividends received by corporations) and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions).

(6) Modifications related to real estate investment trusts—In the case of any taxable year for which part II of subchapter M (relating to real estate investment trusts) applies to the taxpayer—

(A) the net operating loss for such taxable year shall be computed by taking into account the adjustments described in section 857(b)(2) (other than the deduction for dividends paid described in section 857(b)(2)(B));

(B) where such taxable year is a "prior taxable year" referred to in paragraph (2) of subsection (b), the term "taxable income" in such paragraph shall mean "real estate investment trust taxable income" (as defined in section 857(b)(2)); and

(C) subsection (a)(2)(B)(ii)(I) shall be applied by substituting "real estate investment trust taxable income (as defined in section 857(b)(2) but without regard to the deduction for dividends paid (as defined in section 561))" for "taxable income".

[(7) Repealed. Pub. L. 115–97, title I, §13305(b)(3), Dec. 22, 2017, 131 Stat. 2126]—

(8) Qualified business income deduction—Any deduction under section 199A shall not be allowed.

(9) Deduction for foreign-derived deduction eligible income—The deduction under section 250 shall not be allowed.

(e) Law applicable to computations

In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(f) Special rule for insurance companies

In the case of an insurance company (as defined in section 816(a)) other than a life insurance company—

(1) the amount of the deduction allowed under subsection (a) shall be the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, and

(2) subparagraph (C) of subsection (b)(2) shall not apply.

(g) Cross references

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

§197. AMORTIZATION OF GOODWILL AND CERTAIN OTHER INTANGIBLES

(a) General rule

A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

(b) No other depreciation or amortization deduction allowable

Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.

(c) Amortizable section 197 intangible

For purposes of this section—

(1) In general—Except as otherwise provided in this section, the term "amortizable section 197 intangible" means any section 197 intangible—

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

(2) Exclusion of self-created intangibles, etc.—The term "amortizable section 197 intangible" shall not include any section 197 intangible—

(A) which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

(B) which is created by the taxpayer.

This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(3) Anti-churning rules—For exclusion of intangibles acquired in certain transactions, see subsection (f)(9).

(d) Section 197 intangible

For purposes of this section—

(1) In general—Except as otherwise provided in this section, the term "section 197 intangible" means—

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

(2) Customer-based intangible—

(A) In general—The term "customer-based intangible" means—

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) Special rule for financial institutions—In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

(3) Supplier-based intangible—The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

(e) Exceptions

For purposes of this section, the term "section 197 intangible" shall not include any of the following:

(1) Financial interests—Any interest—

(A) in a corporation, partnership, trust, or estate, or

(B) under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.

(2) Land—Any interest in land.

(3) Computer software—

(A) In general—Any—

(i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and

(ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(B) Computer software defined—For purposes of subparagraph (A), the term "computer software" means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

(4) Certain interests or rights acquired separately—Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

(A) Any interest in a film, sound recording, video tape, book, or similar property.

(B) Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

(C) Any interest in a patent or copyright.

(D) To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right—

(i) has a fixed duration of less than 15 years, or

(ii) is fixed as to amount and, without regard to this section, would be recoverable under a method similar to the unit-of-production method.

(5) Interests under leases and debt instruments—Any interest under—

(A) an existing lease of tangible property, or

(B) except as provided in subsection (d)(2)(B), any existing indebtedness.

(6) Mortgage servicing—Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

(7) Certain transaction costs—Any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C.

§199A. QUALIFIED BUSINESS INCOME

(a) Allowance of deduction

In the case of a taxpayer other than a corporation, except as provided in subsection (i), there shall be allowed as a deduction for any taxable year an amount equal to the lesser of—

(1) the combined qualified business income amount of the taxpayer, or

(2) an amount equal to 20 percent of the excess (if any) of—

(A) the taxable income of the taxpayer for the taxable year, over

(B) the net capital gain (as defined in section 1(h)) of the taxpayer for such taxable year.

(b) Combined qualified business income amount

For purposes of this section—

(1) In general—The term "combined qualified business income amount" means, with respect to any taxable year, an amount equal to—

(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

(2) Determination of deductible amount for each trade or business—The amount determined under this paragraph with respect to any qualified trade or business is the lesser of—

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) the greater of—

(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

(3) Modifications to limit based on taxable income—

(A) Exception from limit—In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).

(B) Phase-in of limit for certain taxpayers—

(i) In general—If—

(I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $75,000 ($150,000 in the case of a joint return), and

(II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,

then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

(ii) Amount of reduction—The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as—

(I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to

(II) $75,000 ($150,000 in the case of a joint return).

(iii) Excess amount—For purposes of clause (ii), the excess amount is the excess of—

(I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

(4) Wages, etc.—

(A) In general—The term "W–2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

(B) Limitation to wages attributable to qualified business income—Such term shall not include any amount which is not properly allocable to qualified business income for purposes of subsection (c)(1).

(C) Return requirement—Such term shall not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.

(5) Acquisitions, dispositions, and short taxable years—The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.

(6) Qualified property—For purposes of this section:

(A) In general—The term "qualified property" means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167—

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

(B) Depreciable period—The term "depreciable period" means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of—

(i) the date that is 10 years after such date, or

(ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).

(7) Special rule with respect to income received from cooperatives—In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the amount determined under paragraph (2) with respect to such trade or business shall be reduced by the lesser of—

(A) 9 percent of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or

(B) 50 percent of so much of the W–2 wages with respect to such trade or business as are so allocable.

(c) Qualified business income

For purposes of this section—

(1) In general—The term "qualified business income" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends or qualified publicly traded partnership income.

(2) Carryover of losses—If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.

(3) Qualified items of income, gain, deduction, and loss—For purposes of this subsection—

(A) In general—The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are—

(i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a1 foreign corporation" each place it appears), and

(ii) included or allowed in determining taxable income for the taxable year.

(B) Exceptions—The following items shall not be taken into account as a qualified item of income, gain, deduction, or loss:

(i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

(ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G). Any amount described in section 1385(a)(1) shall not be treated as described in this clause.

(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

(4) Treatment of reasonable compensation and guaranteed payments—Qualified business income shall not include—

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business,

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business, and

(D) any amount with respect to which a deduction is allowable to the taxpayer under section 224(a) for the taxable year.

(d) Qualified trade or business

For purposes of this section—

(1) In general—The term "qualified trade or business" means any trade or business other than—

(A) a specified service trade or business, or

(B) the trade or business of performing services as an employee.

(2) Specified service trade or business—The term "specified service trade or business" means any trade or business—

(A) which is described in section 1202(e)(3)(A) (applied without regard to the words "engineering, architecture,") or which would be so described if the term "employees or owners" were substituted for "employees" therein, or

(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

(3) Exception for specified service businesses based on taxpayer's income—

(A) In general—If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $75,000 ($150,000 in the case of a joint return), then—

(i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

(ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W–2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W–2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

(B) Applicable percentage—For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of—

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $75,000 ($150,000 in the case of a joint return).

(e) Other definitions

For purposes of this section—

(1) Taxable income—Except as otherwise provided in subsection (g)(2)(B), taxable income shall be computed without regard to section 68 and without regard to any deduction allowable under this section.

(2) Threshold amount—

(A) In general—The term "threshold amount" means $157,500 (200 percent of such amount in the case of a joint return).

(B) Inflation adjustment—In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.

The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

(3) Qualified REIT dividend—The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which—

(A) is not a capital gain dividend, as defined in section 857(b)(3), and

(B) is not qualified dividend income, as defined in section 1(h)(11).

(4) Qualified publicly traded partnership income—The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of—

(A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a))2 which is not treated as a corporation under section 7704(c), plus

(B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

§243. DIVIDENDS RECEIVED BY CORPORATIONS

(a) General rule

In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 50 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following); and

(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

(b) Qualifying dividends

(1) In general—For purposes of this section, the term "qualifying dividend" means any dividend received by a corporation—

(A) if at the close of the day on which such dividend is received, such corporation is a member of the same affiliated group as the corporation distributing such dividend, and

(B) if such dividend is distributed out of the earnings and profits of a taxable year of the distributing corporation which ends after December 31, 1963, and on each day of which the distributing corporation and the corporation receiving the dividend were members of such affiliated group.

(2) Affiliated group—For purposes of this subsection:

(A) In general—The term "affiliated group" has the meaning given such term by section 1504(a), except that for such purposes sections 1504(b)(2) and 1504(c) shall not apply.

(B) Group must be consistent in foreign tax treatment—The requirements of paragraph (1)(A) shall not be treated as being met with respect to any dividend received by a corporation if, for any taxable year which includes the day on which such dividend is received—

(i) 1 or more members of the affiliated group referred to in paragraph (1)(A) choose to any extent to take the benefits of section 901, and

(ii) 1 or more other members of such group claim to any extent a deduction for taxes otherwise creditable under section 901.

(3) Special rule for groups which include life insurance companies—

(A) In general—In the case of an affiliated group which includes 1 or more insurance companies under section 801, no dividend by any member of such group shall be treated as a qualifying dividend unless an election under this paragraph is in effect for the taxable year in which the dividend is received. The preceding sentence shall not apply in the case of a dividend described in paragraph (1)(B)(ii).

(B) Effect of election—If an election under this paragraph is in effect with respect to any affiliated group—

(i) part II of subchapter B of chapter 6 (relating to certain controlled corporations) shall be applied with respect to the members of such group without regard to sections 1563(a)(4) and 1563(b)(2)(D), and

(ii) for purposes of this subsection, a distribution by any member of such group which is subject to tax under section 801 shall not be treated as a qualifying dividend if such distribution is out of earnings and profits for a taxable year for which an election under this paragraph is not effective and for which such distributing corporation was not a component member of a controlled group of corporations within the meaning of section 1563 solely by reason of section 1563(b)(2)(D).

(C) Election—An election under this paragraph shall be made by the common parent of the affiliated group and at such time and in such manner as the Secretary shall by regulations prescribe. Any such election shall be binding on all members of such group and may be revoked only with the consent of the Secretary.

(c) Increased percentage for dividends from 20-percent owned corporations

(1) In general—In the case of any dividend received from a 20-percent owned corporation, subsection (a)(1) shall be applied by substituting "65 percent" for "50 percent".

(2) 20-percent owned corporation—For purposes of this section, the term "20-percent owned corporation" means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For purposes of the preceding sentence, stock described in section 1504(a)(4) shall not be taken into account.

§246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED

(c) Exclusion of certain dividends

(1) In general—No deduction shall be allowed under section 243[1] 245, or 245A, in respect of any dividend on any share of stock—

(A) which is held by the taxpayer for 45 days or less during the 91-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(B) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(2) 90-day rule in the case of certain preference dividends—In the case of stock having preference in dividends, if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A) shall be applied—

(A) by substituting "90 days" for "45 days" each place it appears, and

(B) by substituting "181-day period" for "91-day period".

(3) Determination of holding periods—For purposes of this subsection, in determining the period for which the taxpayer has held any share of stock—

(A) the day of disposition, but not the day of acquisition, shall be taken into account, and

(B) paragraph (3) of section 1223 shall not apply.

(4) Holding period reduced for periods where risk of loss diminished—The holding periods determined for purposes of this subsection shall be appropriately reduced (in the manner provided in regulations prescribed by the Secretary) for any period (during such periods) in which—

(A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities,

(B) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or

(C) under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property.

The preceding sentence shall not apply in the case of any qualified covered call (as defined in section 1092(c)(4) but without regard to the requirement that gain or loss with respect to the option not be ordinary income or loss), other than a qualified covered call option to which section 1092(f) applies.

(5) Special rules for foreign source portion of dividends received from specified 10-percent owned foreign corporations—

(A) 1-year holding period requirement—For purposes of section 245A—

(i) paragraph (1)(A) shall be applied—

(I) by substituting "365 days" for "45 days" each place it appears, and

(II) by substituting "731-day period" for "91-day period", and

(ii) paragraph (2) shall not apply.

(B) Status must be maintained during holding period—For purposes of applying paragraph (1) with respect to section 245A, the taxpayer shall be treated as holding the stock referred to in paragraph (1) for any period only if—

(i) the specified 10-percent owned foreign corporation referred to in section 245A(a) is a specified 10-percent owned foreign corporation at all times during such period, and

(ii) the taxpayer is a United States shareholder with respect to such specified 10-percent owned foreign corporation at all times during such period.

§246A. DIVIDENDS RECEIVED DEDUCTION REDUCED WHERE PORTFOLIO STOCK IS DEBT FINANCED

(a) General rule

In the case of any dividend on debt-financed portfolio stock, there shall be substituted for the percentage which (but for this subsection) would be used in determining the amount of the deduction allowable under section 243 or 245(a) a percentage equal to the product of—

(1) 50 percent (65 percent in the case of any dividend from a 20-percent owned corporation as defined in section 243(c)(2)), and

(2) 100 percent minus the average indebtedness percentage.

(c) Debt financed portfolio stock

For purposes of this section—

(1) In general—The term "debt financed portfolio stock" means any portfolio stock if at some time during the base period there is portfolio indebtedness with respect to such stock.

(2) Portfolio stock—The term "portfolio stock" means any stock of a corporation unless—

(A) as of the beginning of the ex-dividend date, the taxpayer owns stock of such corporation—

(i) possessing at least 50 percent of the total voting power of the stock of such corporation, and

(ii) having a value equal to at least 50 percent of the total value of the stock of such corporation, or

(B) as of the beginning of the ex-dividend date—

(i) the taxpayer owns stock of such corporation which would meet the requirements of subparagraph (A) if "20 percent" were substituted for "50 percent" each place it appears in such subparagraph, and

(ii) stock meeting the requirements of subparagraph (A) is owned by 5 or fewer corporate shareholders.

(3) Special rule for stock in a bank or bank holding company—

(A) In general—If, as of the beginning of the ex-dividend date, the taxpayer owns stock of any bank or bank holding company having a value equal to at least 80 percent of the total value of the stock of such bank or bank holding company, for purposes of paragraph (2)(A)(i), the taxpayer shall be treated as owning any stock of such bank or bank holding company which the taxpayer has an option to acquire.

(B) Definitions—For purposes of subparagraph (A)—

(i) Bank—The term "bank" has the meaning given such term by section 581.

(ii) Bank holding company—The term "bank holding company" means a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956).

(4) Treatment of certain preferred stock—For purposes of determining whether the requirements of subparagraph (A) or (B) of paragraph (2) or of subparagraph (A) of paragraph (3) are met, stock described in section 1504(a)(4) shall not be taken into account.

(d) Average indebtedness percentage

For purposes of this section—

(1) In general—Except as provided in paragraph (2), the term "average indebtedness percentage" means the percentage obtained by dividing—

(A) the average amount (determined under regulations prescribed by the Secretary) of the portfolio indebtedness with respect to the stock during the base period, by

(B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of the stock during the base period.

(2) Special rule where stock not held throughout base period—In the case of any stock which was not held by the taxpayer throughout the base period, paragraph (1) shall be applied as if the base period consisted only of that portion of the base period during which the stock was held by the taxpayer.

(3) Portfolio indebtedness—

(A) In general—The term "portfolio indebtedness" means any indebtedness directly attributable to investment in the portfolio stock.

(B) Certain amounts received from short sale treated as indebtedness—For purposes of subparagraph (A), any amount received from a short sale shall be treated as indebtedness for the period beginning on the day on which such amount is received and ending on the day the short sale is closed.

(4) Base period—The term "base period" means, with respect to any dividend, the shorter of—

(A) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for the dividend involved, or

(B) the 1-year period ending on the day before the ex-dividend date for the dividend involved.

§267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS

(a) In general

(1) Deduction for losses disallowed—No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

(2) Matching of deduction and payee income item in the case of expenses and interest—If—

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

(3) Payments to foreign persons—

(A) In general—The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

(B) Special rule for certain foreign entities—

(i) In general—Notwithstanding subparagraph (A), in the case of any item payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) Secretarial authority—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may

prescribe.

(b) Relationships

The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own—

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

(c) Constructive ownership of stock

For purposes of determining, in applying subsection (b), the ownership of stock—

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

§301. DISTRIBUTIONS OF PROPERTY

(a) In general

Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount distributed

(1) General rule—For purposes of this section, the amount of any distribution shall be the amount of money received, plus the fair market value of the other property received.

(2) Reduction for liabilities—The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) Determination of fair market value—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) Amount taxable

In the case of a distribution to which subsection (a) applies—

(1) Amount constituting dividend—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis—

(A) In general—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) Basis

The basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property.

(e) Special rule for certain distributions received by 20 percent corporate shareholder

(1) In general—Except to the extent otherwise provided in regulations, solely for purposes of determining the taxable income of any 20 percent corporate shareholder (and its adjusted basis in the stock of the distributing corporation), section 312 shall be applied with respect to the distributing corporation as if it did not contain subsections (k) and (n) thereof.

(2) 20 percent corporate shareholder—For purposes of this subsection, the term "20 percent corporate shareholder" means, with respect to any distribution, any corporation which owns (directly or through the application of section 318)—

(A) stock in the corporation making the distribution possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote, or

(B) at least 20 percent of the total value of all stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends),

but only if, but for this subsection, the distributee corporation would be entitled to a deduction under section 243 or 245 with respect to such distribution.

(3) Application of section 312(n)(7) not affected—The reference in paragraph (1) to subsection (n) of section 312 shall be treated as not including a reference to paragraph (7) of such subsection.

(4) Regulations—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

(f) Special rules

(1) For distributions in redemption of stock, see section 302.

(2) For distributions in complete liquidation, see part II (sec. 331 and following).

(3) For distributions in corporate organizations and reorganizations, see part III (sec. 351 and following).

(4) For taxation of dividends received by individuals at capital gain rates, see section 1(h)(11).

§302. DISTRIBUTIONS IN REDEMPTION OF STOCK

(a) General rule

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), (4), or (5) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions treated as exchanges

(1) Redemptions not equivalent to dividends—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially disproportionate redemption of stock—

(A) In general—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder's interest—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Redemption from noncorporate shareholder in partial liquidation—Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

(5) Redemptions by certain regulated investment companies—Except to the extent provided in regulations prescribed by the Secretary, subsection (a) shall apply to any distribution in redemption of stock of a publicly offered regulated investment company (within the meaning of section 67(c)(2)(B)) if—

(A) such redemption is upon the demand of the stockholder, and

(B) such company issues only stock which is redeemable upon the demand of the stockholder.

(6) Application of paragraphs—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken

into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) Constructive ownership of stock

(1) In general—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) For determining termination of interest—

(A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary by regulations prescribes, files an agreement to notify the Secretary of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary) notifies the Secretary of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(C) Special rule for waivers by entities—

(i) In general—Subparagraph (A) shall not apply to a distribution to any entity unless—

(I) such entity and each related person meet the requirements of clauses (i), (ii), and (iii) of subparagraph (A), and

(II) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

In any case to which the preceding sentence applies, the second sentence of subparagraph (A) and subparagraph (B)(ii) shall be applied by substituting "distributee or any related person" for "distributee" each place it appears.

(ii) Definitions—For purposes of this subparagraph—

(I) the term "entity" means a partnership, estate, trust, or corporation; and

(II) the term "related person" means any person to whom ownership of stock in the corporation is (at the time of the distribution) attributable under section 318(a)(1) if such stock is further attributable to the entity under section 318(a)(3).

(d) Redemptions treated as distributions of property

Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

§304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS

(a) Treatment of certain stock purchases

(1) Acquisition by related corporation (other than subsidiary) For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. To the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

(2) Acquisition by subsidiary—For purposes of sections 302 and 303, if—

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation,

then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) Special rules for application of subsection (a)

(1) Rules for determinations under section 302(b) In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be

treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

(2) Amount constituting dividend—In the case of any acquisition of stock to which subsection (a) applies, the determination of the amount which is a dividend (and the source thereof) shall be made as if the property were distributed—

(A) by the acquiring corporation to the extent of its earnings and profits, and

(B) then by the issuing corporation to the extent of its earnings and profits.

(3) Coordination with section 351—

(A) Property treated as received in redemption—Except as otherwise provided in this paragraph, subsection (a) (and not section 351 and not so much of sections 357 and 358 as relates to section 351) shall apply to any property received in a distribution described in subsection (a).

(B) Certain assumptions of liability, etc.—

(i) In general—In the case of an acquisition described in section 351, subsection (a) shall not apply to any liability—

(I) assumed by the acquiring corporation, or

(II) to which the stock is subject,

if such liability was incurred by the transferor to acquire the stock. For purposes of the preceding sentence, the term "stock" means stock referred to in paragraph (1)(B) or (2)(A) of subsection (a).

(ii) Extension of obligations, etc.—For purposes of clause (i), an extension, renewal, or refinancing of a liability which meets the requirements of clause (i) shall be treated as meeting such requirements.

(iii) Clause (i) does not apply to stock acquired from related person except where complete termination—Clause (i) shall apply only to stock acquired by the transferor from a person—

(I) none of whose stock is attributable to the transferor under section 318(a) (other than paragraph (4) thereof), or

(II) who satisfies rules similar to the rules of section 302(c)(2) with respect to both the acquiring and the issuing corporations (determined as if such person were a distributee of each such corporation).

(C) Distributions incident to formation of bank holding companies—If—

(i) pursuant to a plan, control of a bank is acquired and within 2 years after the date on which such control is acquired, stock constituting control of such bank is transferred to a BHC in connection with its formation,

(ii) incident to the formation of the BHC there is a distribution of property described in subsection (a), and

(iii) the shareholders of the BHC who receive distributions of such property do not have control of such BHC,

then, subsection (a) shall not apply to any securities received by a qualified minority shareholder incident to the formation of such BHC. For purposes of this subparagraph, any assumption of (or acquisition of stock subject to) a liability under subparagraph (B) shall not be treated as a distribution of property.

(D) Definitions—For purposes of subparagraph (C) and this subparagraph—

(i) Qualified minority shareholder—The term "qualified minority shareholder" means any shareholder who owns less than 10 percent (in value) of the stock of the BHC. For purposes of the preceding sentence, the rules of paragraph (3) of subsection (c) shall apply.

(ii) BHC—The term "BHC" means a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956).

(4) Treatment of certain intragroup transactions—

(A) In general—In the case of any transfer described in subsection (a) of stock from 1 member of an affiliated group to another member of such group, proper adjustments shall be made to—

(i) the adjusted basis of any intragroup stock, and

(ii) the earnings and profits of any member of such group,

to the extent necessary to carry out the purposes of this section.

(B) Definitions—For purposes of this paragraph—

(i) Affiliated group—The term "affiliated group" has the meaning given such term by section 1504(a).

(ii) Intragroup stock—The term "intragroup stock" means any stock which—

(I) is in a corporation which is a member of an affiliated group, and

(II) is held by another member of such group.

(5) Acquisitions by foreign corporations—

(A) In general—In the case of any acquisition to which subsection (a) applies in which the acquiring corporation is a foreign corporation, the only earnings and profits taken into account under paragraph (2)(A) shall be those earnings and profits—

(i) which are attributable (under regulations prescribed by the Secretary) to stock of the acquiring corporation owned (within the meaning of section 958(a)) by a corporation or individual which is—

(I) a United States shareholder (within the meaning of section 951(b)) of the acquiring corporation, and

(II) the transferor or a person who bears a relationship to the transferor described in section 267(b) or 707(b), and

(ii) which were accumulated during the period or periods such stock was owned by such person while the acquiring corporation was a controlled foreign corporation.

(B) Special rule in case of foreign acquiring corporation—In the case of any acquisition to which subsection (a) applies in which the acquiring corporation is a foreign corporation, no earnings and profits shall be taken into account under paragraph (2)(A) (and subparagraph (A) shall not apply) if more than 50

percent of the dividends arising from such acquisition (determined without regard to this subparagraph) would neither—

(i) be subject to tax under this chapter for the taxable year in which the dividends arise, nor

(ii) be includible in the earnings and profits of a controlled foreign corporation (as defined in section 957 and without regard to section 953(c)).

(C) Regulations—The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of this paragraph.

(6) Avoidance of multiple inclusions, etc.—In the case of any acquisition to which subsection (a) applies in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary shall prescribe such regulations as are appropriate in order to eliminate a multiple inclusion of any item in income by reason of this subpart and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961).

(c) Control

(1) In general—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) Stock acquired in the transaction—For purposes of subsection (a)(1)—

(A) General rule—Where 1 or more persons in control of the issuing corporation transfer stock of such corporation in exchange for stock of the acquiring corporation, the stock of the acquiring corporation received shall be taken into account in determining whether such person or persons are in control of the acquiring corporation.

(B) Definition of control group—Where 2 or more persons in control of the issuing corporation transfer stock of such corporation to the acquiring corporation and, after the transfer, the transferors are in control of the acquiring corporation, the person or persons in control of each corporation shall include each of the persons who so transfer stock.

(3) Constructive ownership—

(A) In general—Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of determining control under this section.

(B) Modification of 50-percent limitations in section 318—For purposes of subparagraph (A)—

(i) paragraph (2)(C) of section 318(a) shall be applied by substituting “5 percent” for “50 percent”, and

(ii) paragraph (3)(C) of section 318(a) shall be applied—

(I) by substituting “5 percent” for “50 percent”, and

(II) in any case where such paragraph would not apply but for subclause (I), by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation.

§305. DISTRIBUTIONS OF STOCK AND STOCK RIGHTS

(a) General rule

Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

(b) Exceptions

Subsection (a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which section 301 applies—

(1) Distributions in lieu of money—If the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either—

(A) in its stock, or

(B) in property.

(2) Disproportionate distributions—If the distribution (or a series of distributions of which such distribution is one) has the result of—

(A) the receipt of property by some shareholders, and

(B) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

(3) Distributions of common and preferred stock—If the distribution (or a series of distributions of which such distribution is one) has the result of—

(A) the receipt of preferred stock by some common shareholders, and

(B) the receipt of common stock by other common shareholders.

(4) Distributions on preferred stock—If the distribution is with respect to preferred stock, other than an increase in the conversion ratio of convertible preferred stock made solely to take account of a stock dividend or stock split with respect to the stock into which such convertible stock is convertible.

(5) Distributions of convertible preferred stock—If the distribution is of convertible preferred stock, unless it is established to the satisfaction of the Secretary that such distribution will not have the result described in paragraph (2).

(c) Certain transactions treated as distributions

For purposes of this section and section 301, the Secretary shall prescribe regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is

increased by such change, difference, redemption, or similar transaction. Regulations prescribed under the preceding sentence shall provide that—

(1) where the issuer of stock is required to redeem the stock at a specified time or the holder of stock has the option to require the issuer to redeem the stock, a redemption premium resulting from such requirement or option shall be treated as reasonable only if the amount of such premium does not exceed the amount determined under the principles of section 1273(a)(3),

(2) a redemption premium shall not fail to be treated as a distribution (or series of distributions) merely because the stock is callable, and

(3) in any case in which a redemption premium is treated as a distribution (or series of distributions), such premium shall be taken into account under principles similar to the principles of section 1272(a).

(d) Definitions

(1) Rights to acquire stock—For purposes of this section, the term "stock" includes rights to acquire such stock.

(2) Shareholders—For purposes of subsections (b) and (c), the term "shareholder" includes a holder of rights or of convertible securities.

§306. DISPOSITIONS OF CERTAIN STOCK

(a) General rule

If a shareholder sells or otherwise disposes of section 306 stock (as defined in subsection (c))—

(1) Dispositions other than redemptions—If such disposition is not a redemption (within the meaning of section 317(b))—

(A) The amount realized shall be treated as ordinary income. This subparagraph shall not apply to the extent that—

(i) the amount realized, exceeds

(ii) such stock's ratable share of the amount which would have been a dividend at the time of distribution if (in lieu of section 306 stock) the corporation had distributed money in an amount equal to the fair market value of the stock at the time of distribution.

(B) Any excess of the amount realized over the sum of—

(i) the amount treated under subparagraph (A) as ordinary income, plus

(ii) the adjusted basis of the stock,

shall be treated as gain from the sale of such stock.

(C) No loss shall be recognized.

(D) Treatment as dividend.——For purposes of section 1(h)(11) and such other provisions as the Secretary may specify, any amount treated as ordinary income under this paragraph shall be treated as a dividend received from the corporation.

(2) Redemption—If the disposition is a redemption, the amount realized shall be treated as a distribution of property to which section 301 applies.

(b) Exceptions

Subsection (a) shall not apply—

(1) Termination of shareholder's interest, etc.—

(A) Not in redemption—If the disposition—

(i) is not a redemption;

(ii) is not, directly or indirectly, to a person the ownership of whose stock would (under section 318(a)) be attributable to the shareholder; and

(iii) terminates the entire stock interest of the shareholder in the corporation (and for purposes of this clause, section 318(a) shall apply).

(B) In redemption—If the disposition is a redemption and paragraph (3) or (4) of section 302(b) applies.

(2) Liquidations—If the section 306 stock is redeemed in a distribution in complete liquidation to which part II (sec. 331 and following) applies.

(3) Where gain or loss is not recognized—To the extent that, under any provision of this subtitle, gain or loss to the shareholder is not recognized with respect to the disposition of the section 306 stock.

(4) Transactions not in avoidance—If it is established to the satisfaction of the Secretary—

(A) that the distribution, and the disposition or redemption, or

(B) in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,

was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(c) Section 306 stock defined

(1) In general—For purposes of this subchapter, the term "section 306 stock" means stock which meets the requirements of subparagraph (A), (B), or (C) of this paragraph.

(A) Distributed to seller—Stock (other than common stock issued with respect to common stock) which was distributed to the shareholder selling or otherwise disposing of such stock if, by reason of section 305(a), any part of such distribution was not includible in the gross income of the shareholder.

(B) Received in a corporate reorganization or separation—Stock which is not common stock and—

(i) which was received, by the shareholder selling or otherwise disposing of such stock, in pursuance of a plan of reorganization (within the meaning of section 368(a)), or in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applied, and

(ii) with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of part III, but only to the extent that either the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock.

For purposes of this section, a receipt of stock to which the foregoing provisions of this subparagraph apply shall be treated as a distribution of stock.

(C) Stock having transferred or substituted basis—Except as otherwise provided in subparagraph (B), stock the basis of which (in the hands of the shareholder selling or otherwise disposing of such stock) is determined by reference to the basis (in the hands of such shareholder or any other person) of section 306 stock.

(2) Exception where no earnings and profits—For purposes of this section, the term "section 306 stock" does not include any stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock.

(3) Certain stock acquired in section 351 exchange—The term "section 306 stock" also includes any stock which is not common stock acquired in an exchange to which section 351 applied if receipt of money (in lieu of the stock) would have been treated as a dividend to any extent. Rules similar to the rules of section 304(b)(2) shall apply—

(A) for purposes of the preceding sentence, and

(B) for purposes of determining the application of this section to any subsequent disposition of stock which is section 306 stock by reason of an exchange described in the preceding sentence.

(4) Application of attribution rules for certain purposes—For purposes of paragraphs (1)(B)(ii) and (3), section 318(a) shall apply. For purposes of applying the preceding sentence to paragraph (3), the rules of section 304(c)(3)(B) shall apply.

(d) Stock rights

For purposes of this section—

(1) stock rights shall be treated as stock, and

(2) stock acquired through the exercise of stock rights shall be treated as stock distributed at the time of the distribution of the stock rights, to the extent of the fair market value of such rights at the time of the distribution.

§307. BASIS OF STOCK AND STOCK RIGHTS ACQUIRED IN DISTRIBUTIONS

(a) General rule

If a shareholder in a corporation receives its stock or rights to acquire its stock (referred to in this subsection as "new stock") in a distribution to which section 305(a) applies, then the basis of such new stock and of the stock with respect to which it is distributed (referred to in this section as "old stock"), respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be made under regulations prescribed by the Secretary.

§311. TAXABILITY OF CORPORATION ON DISTRIBUTION

(a) General rule

Except as provided in subsection (b), no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of—

(1) its stock (or rights to acquire its stock), or

(2) property.

(b) Distributions of appreciated property

(1) In general—If—

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(2) Treatment of liabilities—Rules similar to the rules of section 336(b) shall apply for purposes of this subsection.

(3) Special rule for certain distributions of partnership or trust interests—If the property distributed consists of an interest in a partnership or trust, the Secretary may by regulations provide that the amount of the gain recognized under paragraph (1) shall be computed without regard to any loss attributable to property contributed to the partnership or trust for the principal purpose of recognizing such loss on the distribution.

§316. DIVIDEND DEFINED

(a) General rule

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

§317. OTHER DEFINITIONS

(a) Property

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of stock
For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

§318. CONSTRUCTIVE OWNERSHIP OF STOCK

(a) General rule

For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) Members of family—

(A) In general—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) Effect of adoption—For purposes of subparagraph (A)(ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) Attribution from partnerships, estates, trusts, and corporations—

(A) From partnerships and estates—Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

(B) From trusts—

(i) Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

(ii) Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(C) From corporations—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(3) Attribution to partnerships, estates, trusts, and corporations—

(A) To partnerships and estates—Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(B) To trusts—

(i) Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

(ii) Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(C) To corporations—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

(4) Options—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(5) Operating rules—

(A) In general—Except as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), or (4), shall, for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person.

(B) Members of family—Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be considered as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

(C) Partnerships, estates, trusts, and corporations—Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

(D) Option rule in lieu of family rule—For purposes of this paragraph, if stock may be considered as owned by an individual under paragraph (1) or (4), it shall be considered as owned by him under paragraph (4).

(E) S corporation treated as partnership—For purposes of this subsection—

(i) an S corporation shall be treated as a partnership, and

(ii) any shareholder of the S corporation shall be treated as a partner of such partnership.

The preceding sentence shall not apply for purposes of determining whether stock in the S corporation is constructively owned by any person.

(b) Cross references

For provisions to which the rules contained in subsection (a) apply, see—

(1) section 302 (relating to redemption of stock);

(2) section 304 (relating to redemption by related corporations);

(3) section 306(b)(1)(A) (relating to disposition of section 306 stock);

(4) section 338(h)(3) (defining purchase);

(5) section 382(*l*)**(3) (relating to special limitations on net operating loss carryovers);**

(6) section 856(d) (relating to definition of rents from real property in the case of real estate investment trusts);

(7) section 958(b) (relating to constructive ownership rules with respect to controlled foreign corporations); and

(8) section 6038(e)(2) (relating to information with respect to certain foreign corporations).

§331. GAIN OR LOSS TO SHAREHOLDER IN CORPORATE LIQUIDATIONS

(a) Distributions in complete liquidation treated as exchanges
Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(b) Nonapplication of section 301
Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property (other than a distribution referred to in paragraph (2)(B) of section 316(b)) in complete liquidation.

(c) Cross reference
For general rule for determination of the amount of gain or loss recognized, see section 1001.

§332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES

(a) General rule
No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) Liquidations to which section applies

For purposes of this section, a distribution shall be considered to be in complete liquidation only if—

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2); and either

(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(3) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such

period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year, the Secretary may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such 3-year period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, the assessment and collection of all income taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this subsection shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for purposes of this subsection a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (A) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, on an exchange described in section 361, and (B) the complete cancellation or redemption under the plan, as a result of exchanges described in section 354, of the shares not owned by the taxpayer.

(c) Deductible liquidating distributions of regulated investment companies and real estate investment trusts

If a corporation receives a distribution from a regulated investment company or a real estate investment trust which is considered under subsection (b) as being in complete liquidation of such company or trust, then, notwithstanding any other provision of this chapter, such corporation shall recognize and treat as a dividend from such company or trust an amount equal to the deduction for dividends paid allowable to such company or trust by reason of such distribution.

(d) Recognition of gain on liquidation of certain holding companies

(1) In general—In the case of any distribution to a foreign corporation in complete liquidation of an applicable holding company—

(A) subsection (a) and section 331 shall not apply to such distribution, and

(B) such distribution shall be treated as a distribution of property to which section 301 applies.

(2) Applicable holding company—For purposes of this subsection:

(A) In general—The term “applicable holding company” means any domestic corporation—

(i) which is a common parent of an affiliated group,

(ii) stock of which is directly owned by the distributee foreign corporation,

(iii) substantially all of the assets of which consist of stock in other members of such affiliated group, and

(iv) which has not been in existence at all times during the 5 years immediately preceding the date of the liquidation.

(B) Affiliated group—For purposes of this subsection, the term “affiliated group” has the meaning given such term by section 1504(a) (without regard to paragraph (2) of section 1504(b)).

(3) Coordination with subpart F—If the distributee of a distribution described in paragraph (1) is a controlled foreign corporation (as defined in section 957), then notwithstanding paragraph (1) or subsection (a), such distribution shall be treated as a distribution to which section 331 applies.

(4) Regulations—The Secretary shall provide such regulations as appropriate to prevent the abuse of this subsection, including regulations which provide, for the purposes of clause (iv) of paragraph (2)(A), that a corporation is not in existence for any period unless it is engaged in the active conduct of a trade or business or owns a significant ownership interest in another corporation so engaged.

§334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS

(a) General rule
If property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

(b) Liquidation of subsidiary

(1) In general—If property is received by a corporate distributee in a distribution in a complete liquidation to which section 332 applies (or in a transfer described in section 337(b)(1)), the basis of such property in the hands of such distributee shall be the same as it would be in the hands of the transferor; except that, in the hands of such distributee—

(A) the basis of such property shall be the fair market value of the property at the time of the distribution in any case in which gain or loss is recognized by the liquidating corporation with respect to such property, and

(B) the basis of any property described in section 362(e)(1)(B) shall be the fair market value of the property at the time of the distribution in any case in which such distributee's aggregate adjusted basis of such property would (but for this subparagraph) exceed the fair market value of such property immediately after such liquidation.

(2) Corporate distributee—For purposes of this subsection, the term "corporate distributee" means only the corporation which meets the stock ownership requirements specified in section 332(b).

§336. GAIN OR LOSS RECOGNIZED ON PROPERTY DISTRIBUTED IN COMPLETE LIQUIDATION

(a) General rule
Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

(b) Treatment of liabilities
If any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, for purposes of subsection (a) and section 337, the fair market value of such property shall be treated as not less than the amount of such liability.

(c) Exception for liquidations which are part of a reorganization

For provision providing that this subpart does not apply to distributions in pursuance of a plan of reorganization, see section 361(c)(4).

(d) Limitations on recognition of loss

(1) No loss recognized in certain distributions to related persons—

(A) In general—No loss shall be recognized to a liquidating corporation on the distribution of any property to a related person (within the meaning of section 267) if—

(i) such distribution is not pro rata, or

(ii) such property is disqualified property.

(B) Disqualified property—For purposes of subparagraph (A), the term "disqualified property" means any property which is acquired by the liquidating corporation in a transaction to which section 351 applied, or as a contribution to capital, during the 5-year period ending on the date of the distribution. Such term includes any property if the adjusted basis of such property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

(2) Special rule for certain property acquired in certain carryover basis transactions—

(A) In general—For purposes of determining the amount of loss recognized by any liquidating corporation on any sale, exchange, or distribution of property described in subparagraph (B), the adjusted basis of such property shall be reduced (but not below zero) by the excess (if any) of—

(i) the adjusted basis of such property immediately after its acquisition by such corporation, over

(ii) the fair market value of such property as of such time.

(B) Description of property—

(i) In general—For purposes of subparagraph (A), property is described in this subparagraph if—

(I) such property is acquired by the liquidating corporation in a transaction to which section 351 applied or as a contribution to capital, and

(II) the acquisition of such property by the liquidating corporation was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation.

Other property shall be treated as so described if the adjusted basis of such other property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

(ii) Certain acquisitions treated as part of plan—For purposes of clause (i), any property described in clause (i)(I) acquired by the liquidated corporation after the date 2 years before the date of the adoption of the plan of complete liquidation shall, except as provided in regulations, be treated as acquired as part of a plan described in clause (i)(II).

(C) Recapture in lieu of disallowance—The Secretary may prescribe regulations under which, in lieu of disallowing a loss under subparagraph (A) for a prior taxable year, the gross income of the liquidating corporation for the taxable year in which the plan of complete liquidation is adopted shall be increased by the amount of the disallowed loss.

(3) Special rule in case of liquidation to which section 332 applies—In the case of any liquidation to which section 332 applies, no loss shall be recognized to the liquidating corporation on any distribution in such liquidation. The preceding sentence shall apply to any distribution to the 80-percent distributee only if subsection (a) or (b)(1) of section 337 applies to such distribution.

§337. NONRECOGNITION FOR PROPERTY DISTRIBUTED TO PARENT IN COMPLETE LIQUIDATION OF SUBSIDIARY

(a) In general

No gain or loss shall be recognized to the liquidating corporation on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies.

(b) Treatment of indebtedness of subsidiary, etc.

(1) Indebtedness of subsidiary to parent—If—

(A) a corporation is liquidated in a liquidation to which section 332 applies, and

(B) on the date of the adoption of the plan of liquidation, such corporation was indebted to the 80-percent distributee,

for purposes of this section and section 336, any transfer of property to the 80-percent distributee in satisfaction of such indebtedness shall be treated as a distribution to such distributee in such liquidation.

(2) Treatment of tax-exempt distributee—

(A) In general—Except as provided in subparagraph (B), paragraph (1) and subsection (a) shall not apply where the 80-percent distributee is an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(B) Exception where property will be used in unrelated business—

(i) In general—Subparagraph (A) shall not apply to any distribution of property to an organization described in section 511(a)(2) if, immediately after such distribution, such organization uses such property in an activity the income from which is subject to tax under section 511(a).

(ii) Later disposition or change in use—If any property to which clause (i) applied is disposed of by the organization acquiring such property, notwithstanding any other provision of law, any gain (not in excess of the amount not recognized by reason of clause (i)) shall be included in such organization's unrelated business taxable income. For purposes of the preceding sentence, if such property ceases to be used in an activity referred to in clause (i), such organization shall be treated as having disposed of such property on the date of such cessation.

(c) 80-percent distributee

For purposes of this section, the term "80-percent distributee" means only the corporation which meets the 80-percent stock ownership requirements specified in section 332(b). For purposes of this section, the determination of whether any corporation is an 80-percent distributee shall be made without regard to any consolidated return regulation.

(d) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including—

(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity, and

(2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.

§338. CERTAIN STOCK PURCHASES TREATED AS ASSET ACQUISITIONS

(a) General rule

For purposes of this subtitle, if a purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election), then, in the case of any qualified stock purchase, the target corporation—

(1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and

(2) shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1) as of the beginning of the day after the acquisition date.

(b) Basis of assets after deemed purchase

(1) In general—For purposes of subsection (a), the assets of the target corporation shall be treated as purchased for an amount equal to the sum of—

(A) the grossed-up basis of the purchasing corporation's recently purchased stock, and

(B) the basis of the purchasing corporation's nonrecently purchased stock.

(2) Adjustment for liabilities and other relevant items—The amount described in paragraph (1) shall be adjusted under regulations prescribed by the Secretary for liabilities of the target corporation and other relevant items.

(3) Election to step-up the basis of certain target stock—

(A) In general—Under regulations prescribed by the Secretary, the basis of the purchasing corporation's nonrecently purchased stock shall be the basis amount determined under subparagraph (B) of this paragraph if the purchasing corporation makes an election to recognize gain as if such stock were sold on the acquisition date for an amount equal to the basis amount determined under subparagraph (B).

(B) Determination of basis amount—For purposes of subparagraph (A), the basis amount determined under this subparagraph shall be an amount equal to the grossed-up basis determined under subparagraph (A) of paragraph (1) multiplied by a fraction—

(i) the numerator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and

(ii) the denominator of which is 100 percent minus the percentage referred to in clause (i).

(4) Grossed-up basis—For purposes of paragraph (1), the grossed-up basis shall be an amount equal to the basis of the corporation's recently purchased stock, multiplied by a fraction—

(A) the numerator of which is 100 percent, minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and

(B) the denominator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.

(5) Allocation among assets—The amount determined under paragraphs (1) and (2) shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary.

(6) Definitions of recently purchased stock and nonrecently purchased stock—For purposes of this subsection—

(A) Recently purchased stock—The term "recently purchased stock" means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which was purchased by such corporation during the 12-month acquisition period.

(B) Nonrecently purchased stock—The term "nonrecently purchased stock" means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which is not recently purchased stock.

(d) Purchasing corporation; target corporation; qualified stock purchase

For purposes of this section—

(1) Purchasing corporation—The term "purchasing corporation" means any corporation which makes a qualified stock purchase of stock of another corporation.

(2) Target corporation—The term "target corporation" means any corporation the stock of which is acquired by another corporation in a qualified stock purchase.

(3) Qualified stock purchase—The term "qualified stock purchase" means any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of 1 corporation is acquired by another corporation by purchase during the 12-month acquisition period.

(g) Election

(1) When made—Except as otherwise provided in regulations, an election under this section shall be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(2) Manner—An election by the purchasing corporation under this section shall be made in such manner as the Secretary shall by regulations prescribe.

(3) Election irrevocable—An election by a purchasing corporation under this section, once made, shall be irrevocable.

(h) Definitions and special rules

For purposes of this section—

(1) 12-month acquisition period—The term "12-month acquisition period" means the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase (or, if any of such stock was acquired in an acquisition which is a purchase by reason of subparagraph (C) of paragraph (3), the date on which the acquiring corporation is first considered under section 318(a) (other than paragraph (4) thereof) as owning stock owned by the corporation from which such acquisition was made).

(2) Acquisition date—The term "acquisition date" means, with respect to any corporation, the first day on which there is a qualified stock purchase with respect to the stock of such corporation.

(3) Purchase—

(A) In general—The term "purchase" means any acquisition of stock, but only if—

(i) the basis of the stock in the hands of the purchasing corporation is not determined (I) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (II) under section 1014(a) (relating to property acquired from a decedent),

(ii) the stock is not acquired in an exchange to which section 351, 354, 355, or 356 applies and is not acquired in any other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized on the transaction, and

(iii) the stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock.

(B) Deemed purchase under subsection (a) The term "purchase" includes any deemed purchase under subsection (a)(2). The acquisition date for a corporation which is deemed purchased under subsection (a)(2) shall be determined under regulations prescribed by the Secretary.

(C) Certain stock acquisitions from related corporations—

(i) In general—Clause (iii) of subparagraph (A) shall not apply to an acquisition of stock from a related corporation if at least 50 percent in value of the stock of such related corporation was acquired by purchase (within the meaning of subparagraphs (A) and (B)).

(ii) Certain distributions—Clause (i) of subparagraph (A) shall not apply to an acquisition of stock described in clause (i) of this subparagraph if the corporation acquiring such stock—

(I) made a qualified stock purchase of stock of the related corporation, and

(II) made an election under this section (or is treated under subsection (e) as having made such an election) with respect to such qualified stock purchase.

(iii) Related corporation defined—For purposes of this subparagraph, a corporation is a related corporation if stock owned by such corporation is treated (under section 318(a) other than paragraph (4) thereof) as owned by the corporation acquiring the stock.

(4) Consistency period—

(A) In general—Except as provided in subparagraph (B), the term "consistency period" means the period consisting of—

(i) the 1-year period before the beginning of the 12-month acquisition period for the target corporation,

(ii) such acquisition period (up to and including the acquisition date), and

(iii) the 1-year period beginning on the day after the acquisition date.

(B) Extension where there is plan—The period referred to in subparagraph (A) shall also include any period during which the Secretary determines that there was in effect a plan to make a qualified stock purchase plus 1 or more other qualified stock purchases (or asset acquisitions described in subsection (e)) with respect to the target corporation or any target affiliate.

(5) Affiliated group—The term "affiliated group" has the meaning given to such term by section 1504(a) (determined without regard to the exceptions contained in section 1504(b)).

(6) Target affiliate—

(A) In general—A corporation shall be treated as a target affiliate of the target corporation if each of such corporations was, at any time during so much of the consistency period as ends on the acquisition date of the target corporation, a member of an affiliated group which had the same common parent.

(B) Certain foreign corporations, etc.—Except as otherwise provided in regulations (and subject to such conditions as may be provided in regulations)—

(i) the term "target affiliate" does not include a foreign corporation or a DISC, and

(ii) stock held by a target affiliate in a foreign corporation or a domestic corporation which is a DISC or described in section 1248(e) shall be excluded from the operation of this section.

[(7) Repealed. Pub. L. 100–647, title I, §1006(e)(20), Nov. 10, 1988, 102 Stat. 3403]—

(8) Acquisitions by affiliated group treated as made by 1 corporation—Except as provided in regulations prescribed by the Secretary, stock and asset acquisitions made by members of the same affiliated group shall be treated as made by 1 corporation.

(9) Target not treated as member of affiliated group—Except as otherwise provided in paragraph (10) or in regulations prescribed under this paragraph, the target corporation shall not be treated as a member of an affiliated group with respect to the sale described in subsection (a)(1).

(10) Elective recognition of gain or loss by target corporation, together with nonrecognition of gain or loss on stock sold by selling consolidated group—

(A) In general—Under regulations prescribed by the Secretary, an election may be made under which if—

(i) the target corporation was, before the transaction, a member of the selling consolidated group, and

(ii) the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction,

then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

(B) Selling consolidated group—For purposes of subparagraph (A), the term "selling consolidated group" means any group of corporations which (for the taxable period which includes the transaction)—

(i) includes the target corporation, and

(ii) files a consolidated return.

To the extent provided in regulations, such term also includes any affiliated group of corporations which includes the target corporation (whether or not such group files a consolidated return).

(C) Information required to be furnished to the Secretary—Under regulations, where an election is made under subparagraph (A), the purchasing corporation and the common parent of the selling consolidated group shall, at such times and in such manner as may be provided in regulations, furnish to the Secretary the following information:

(i) The amount allocated under subsection (b)(5) to goodwill or going concern value.

(ii) Any modification of the amount described in clause (i).

(iii) Any other information as the Secretary deems necessary to carry out the provisions of this paragraph.

(11) Elective formula for determining fair market value—For purposes of subsection (a)(1), fair market value may be determined on the basis of a formula provided in regulations prescribed by the Secretary which takes into account liabilities and other relevant items.

[(12) Repealed. Pub. L. 99–514, title VI, §631(e)(5), Oct. 22, 1986, 100 Stat. 2273]—

(13) Tax on deemed sale not taken into account for estimated tax purposes—For purposes of section 6655, tax attributable to the sale described in subsection (a)(1) shall not be taken into account. The preceding sentence shall not apply with respect to a qualified stock purchase for which an election is made under paragraph (10).

[(14) Repealed. Pub. L. 108–27, title III, §302(e)(4)(B)(i), May 28, 2003, 117 Stat. 763]—

(15) Combined deemed sale return—Under regulations prescribed by the Secretary, a combined deemed sale return may be filed by all target corporations acquired by a purchasing corporation on the same acquisition date if such target corporations were members of the same selling consolidated group (as defined in subparagraph (B) of paragraph (10)).

(16) Coordination with foreign tax credit provisions—Except as provided in regulations, this section shall not apply for purposes of determining the source or character of any item for purposes of subpart A of part III of subchapter N of this chapter (relating to foreign tax credit). The preceding sentence shall not apply to any gain to the extent such gain is includible in gross income as a dividend under section 1248 (determined without regard to any deemed sale under this section by a foreign corporation).

§346. DEFINITION AND SPECIAL RULE

(a) Complete liquidation
For purposes of this subchapter, a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.

§351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR

(a) General rule
No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control

(as defined in section 368(c)) of the corporation.

(b) Receipt of property

If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special rules where distribution to shareholders

(1) In general—In determining control for purposes of this section, the fact that any corporate transferor distributes part or all of the stock in the corporation which it receives in the exchange to its shareholders shall not be taken into account.

(2) Special rule for section 355—If the requirements of section 355 (or so much of section 356 as relates to section 355) are met with respect to a distribution described in paragraph (1), then, solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account in determining control for purposes of this section.

(d) Services, certain indebtedness, and accrued interest not treated as property

For purposes of this section, stock issued for—

(1) services,

(2) indebtedness of the transferee corporation which is not evidenced by a security, or

(3) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt,

shall not be considered as issued in return for property.

(f) Treatment of controlled corporation

If—

(1) property is transferred to a corporation (hereinafter in this subsection referred to as the "controlled corporation") in an exchange with respect to which gain or loss is not recognized (in whole or in part) to the transferor under this section, and

(2) such exchange is not in pursuance of a plan of reorganization,

section 311 shall apply to any transfer in such exchange by the controlled corporation in the same manner as if such transfer were a distribution to which subpart A of part I applies.

(g) Nonqualified preferred stock not treated as stock

(1) In general—In the case of a person who transfers property to a corporation and receives nonqualified preferred stock—

(A) subsection (a) shall not apply to such transferor, and

(B) if (and only if) the transferor receives stock other than nonqualified preferred stock—

(i) subsection (b) shall apply to such transferor; and

(ii) such nonqualified preferred stock shall be treated as other property for purposes of applying subsection (b).

(2) Nonqualified preferred stock—For purposes of paragraph (1)—

(A) In general—The term "nonqualified preferred stock" means preferred stock if—

(i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock,

(ii) the issuer or a related person is required to redeem or purchase such stock,

(iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or

(iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

(B) Limitations—Clauses (i), (ii), and (iii) of subparagraph (A) shall apply only if the right or obligation referred to therein may be exercised within the 20-year period beginning on the issue date of such stock and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

(C) Exceptions for certain rights or obligations—

(i) In general—A right or obligation shall not be treated as described in clause (i), (ii), or (iii) of subparagraph (A) if—

(I) it may be exercised only upon the death, disability, or mental incompetency of the holder, or

(II) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.

(ii) Exception—Clause (i)(I) shall not apply if the stock relinquished in the exchange, or the stock acquired in the exchange is in—

(I) a corporation if any class of stock in such corporation or a related party is readily tradable on an established securities market or otherwise, or

(II) any other corporation if such exchange is part of a transaction or series of transactions in which such corporation is to become a corporation described in subclause (I).

(3) Definitions—For purposes of this subsection—

(A) Preferred stock—The term "preferred stock" means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Stock shall not be treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation. If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.

(B) Related person—A person shall be treated as related to another person if they bear a relationship to such other person described in section 267(b) or 707(b).

(4) Regulations—The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection and sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Secretary may also prescribe regulations, consistent with the treatment under this subsection and such sections, for the treatment of nonqualified preferred stock under other provisions of this title.

§354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS

(a) General rule

(1) In general—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) Limitation—

(A) Excess principal amount—Paragraph (1) shall not apply if—

(i) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(ii) any such securities are received and no such securities are surrendered.

(B) Property attributable to accrued interest—Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock (including nonqualified preferred stock, as defined in section 351(g)(2)), securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

(C) Nonqualified preferred stock—

(i) In general—Nonqualified preferred stock (as defined in section 351(g)(2)) received in exchange for stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities.

(ii) Recapitalizations of family-owned corporations—

(I) In general—Clause (i) shall not apply in the case of a recapitalization under section 368(a)(1)(E) of a family-owned corporation.

(II) Family-owned corporation—For purposes of this clause, except as provided in regulations, the term "family-owned corporation" means any corporation which is described in clause (i) of section 447(d)(2)(C)1 throughout the 8-year period beginning on the date which is 5 years before the date of the recapitalization. For purposes of the preceding sentence, stock shall not be treated

as owned by a family member during any period described in section 355(d)(6)(B).

(III) Extension of statute of limitations—The statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of 3 years after the date the Secretary is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(3) Cross references—

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including nonqualified preferred stock and an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.

(B) For treatment of accrued interest in the case of an exchange described in paragraph (2)(B), see section 61.

(b) Exception

(1) In general—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) Cross reference—For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1), see section 355.

§355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION

(a) Effect on distributees

(1) General rule—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of

the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitations—

(A) Excess principal amount—Paragraph (1) shall not apply if—

(i) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(ii) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

(B) Stock acquired in taxable transactions within 5 years treated as boot—For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—

(i) which occurs within 5 years of the distribution of such stock, and

(ii) in which gain or loss was recognized in whole or in part,

shall not be treated as stock of such controlled corporation, but as other property.

(C) Property attributable to accrued interest—Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock (including nonqualified preferred stock, as defined in section 351(g)(2)), securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

(D) Nonqualified preferred stock—Nonqualified preferred stock (as defined in section 351(g)(2)) received in a distribution with respect to stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities.

(4) Cross references—

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including nonqualified preferred stock and an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (3)(C) applies), see section 356.

(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(C), see section 61.

(b) Requirements as to active business

(1) In general—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired by any distributee corporation directly (or through 1 or more corporations, whether through the distributing corporation or otherwise) within the period described in subparagraph (B) and was not acquired by the distributing corporation directly (or through 1 or more corporations) within such period, or

(ii) was so acquired by any such corporation within such period, but, in each case in which such control was so acquired, it was so acquired, only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

For purposes of subparagraph (D), all distributee corporations which are members of the same affiliated group (as defined in section 1504(a) without regard to section 1504(b)) shall be treated as 1 distributee

corporation.

(3) Special rules for determining active conduct in the case of affiliated groups—

(A) In general—For purposes of determining whether a corporation meets the requirements of paragraph (2)(A), all members of such corporation's separate affiliated group shall be treated as one corporation.

(B) Separate affiliated group—For purposes of this paragraph, the term "separate affiliated group" means, with respect to any corporation, the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply.

(C) Treatment of trade or business conducted by acquired member—If a corporation became a member of a separate affiliated group as a result of one or more transactions in which gain or loss was recognized in whole or in part, any trade or business conducted by such corporation (at the time that such corporation became such a member) shall be treated for purposes of paragraph (2) as acquired in a transaction in which gain or loss was recognized in whole or in part.

(D) Regulations—The Secretary shall prescribe such regulations as are necessary or appropriate to carry out the purposes of this paragraph, including regulations which provide for the proper application of subparagraphs (B), (C), and (D) of paragraph (2), and modify the application of subsection (a)(3)(B), in connection with the application of this paragraph.

(c) Taxability of corporation on distribution

(1) In general—Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation on any distribution to which this section (or so much of section 356 as relates to this section) applies and which is not in pursuance of a plan of reorganization.

(2) Distribution of appreciated property—

(A) In general—If—

(i) in a distribution referred to in paragraph (1), the corporation distributes property other than qualified property, and

(ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(B) Qualified property—For purposes of subparagraph (A), the term "qualified property" means any stock or securities in the controlled corporation.

(C) Treatment of liabilities—If any property distributed in the distribution referred to in paragraph (1) is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, then, for purposes of subparagraph (A), the fair market value of such property shall be treated as not less than the amount of such liability.

(3) Coordination with sections 311 and 336(a) Sections 311 and 336(a) shall not apply to any distribution referred to in paragraph (1).

(d) Recognition of gain on certain distributions of stock or securities in controlled corporation

(1) In general—In the case of a disqualified distribution, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

(2) Disqualified distribution—For purposes of this subsection, the term "disqualified distribution" means any distribution to which this section (or so much of section 356 as relates to this section) applies if, immediately after the distribution—

(A) any person holds disqualified stock in the distributing corporation which constitutes a 50-percent or greater interest in such corporation, or

(B) any person holds disqualified stock in the controlled corporation (or, if stock of more than 1 controlled corporation is distributed, in any controlled corporation) which constitutes a 50-percent or greater interest in such corporation.

(3) Disqualified stock—For purposes of this subsection, the term "disqualified stock" means—

(A) any stock in the distributing corporation acquired by purchase during the 5-year period ending on the date of the distribution, and

(B) any stock in any controlled corporation—

(i) acquired by purchase during the 5-year period ending on the date of the distribution, or

(ii) received in the distribution to the extent attributable to distributions on—

(I) stock described in subparagraph (A), or

(II) any securities in the distributing corporation acquired by purchase during the 5-year period ending on the date of the distribution.

(4) 50-percent or greater interest—For purposes of this subsection, the term "50-percent or greater interest" means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.

(5) Purchase—For purposes of this subsection—

(A) In general—Except as otherwise provided in this paragraph, the term "purchase" means any acquisition but only if—

(i) the basis of the property acquired in the hands of the acquirer is not determined (I) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (II) under section 1014(a), and

(ii) the property is not acquired in an exchange to which section 351, 354, 355, or 356 applies.

(B) Certain section 351 exchanges treated as purchases—The term "purchase" includes any acquisition of property in an exchange to which section 351 applies to the extent such property is acquired in exchange for—

(i) any cash or cash item,

(ii) any marketable stock or security, or

(iii) any debt of the transferor.

(C) Carryover basis transactions—If—

(i) any person acquires property from another person who acquired such property by purchase (as determined under this paragraph with regard to this subparagraph), and

(ii) the adjusted basis of such property in the hands of such acquirer is determined in whole or in part by reference to the adjusted basis of such property in the hands of such other person,

such acquirer shall be treated as having acquired such property by purchase on the date it was so acquired by such other person.

(6) Special rule where substantial diminution of risk—

(A) In general—If this paragraph applies to any stock or securities for any period, the running of any 5-year period set forth in subparagraph (A) or (B) of paragraph (3) (whichever applies) shall be suspended during such period.

(B) Property to which suspension applies—This paragraph applies to any stock or securities for any period during which the holder's risk of loss with respect to such stock or securities, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by—

(i) an option,

(ii) a short sale,

(iii) any special class of stock, or

(iv) any other device or transaction.

(7) Aggregation rules—

(A) In general—For purposes of this subsection, a person and all persons related to such person (within the meaning of section 267(b) or 707(b)(1)) shall be treated as one person.

(B) Persons acting pursuant to plans or arrangements—If two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing corporation or controlled corporation, such persons shall be treated as one person for purposes of this subsection.

(8) Attribution from entities—

(A) In general—Paragraph (2) of section 318(a) shall apply in determining whether a person holds stock or securities in any corporation (determined by substituting "10 percent" for "50 percent" in subparagraph (C) of such paragraph (2) and by treating any reference to stock as including a reference to securities).

(B) Deemed purchase rule—If—

(i) any person acquires by purchase an interest in any entity, and

(ii) such person is treated under subparagraph (A) as holding any stock or securities by reason of holding such interest,

such stock or securities shall be treated as acquired by purchase by such person on the later of the date of the purchase of the interest in such entity or the date such stock or securities are acquired by purchase by such entity.

(9) Regulations—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including—

(A) regulations to prevent the avoidance of the purposes of this subsection through the use of related persons, intermediaries, pass-thru entities, options, or other arrangements, and

(B) regulations modifying the definition of the term "purchase".

(e) Recognition of gain on certain distributions of stock or securities in connection with acquisitions

(1) General rule—If there is a distribution to which this subsection applies, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

(2) Distributions to which subsection applies—

(A) In general—This subsection shall apply to any distribution—

(i) to which this section (or so much of section 356 as relates to this section) applies, and

(ii) which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

(B) Plan presumed to exist in certain cases—If 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution, such acquisition shall be treated as pursuant to a plan described in subparagraph (A)(ii) unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.

(C) Certain plans disregarded—A plan (or series of related transactions) shall not be treated as described in subparagraph (A)(ii) if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group (as defined in section 1504 without regard to subsection (b) thereof).

(D) Coordination with subsection (d) This subsection shall not apply to any distribution to which subsection (d) applies.

(3) Special rules relating to acquisitions—

(A) Certain acquisitions not taken into account—Except as provided in regulations, the following acquisitions shall not be taken into account in applying paragraph (2)(A)(ii):

(i) The acquisition of stock in any controlled corporation by the distributing corporation.

(ii) The acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation.

(iii) The acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation.

(iv) The acquisition of stock in the distributing corporation or any controlled corporation to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

This subparagraph shall not apply to any acquisition if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) described in paragraph (2)(A)(ii).

(B) Asset acquisitions—Except as provided in regulations, for purposes of this subsection, if the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in a transaction described in subparagraph (A), (C), or (D) of section 368(a)(1) or any other transaction specified in regulations by the Secretary, the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired.

(4) Definition and special rules—For purposes of this subsection—

(A) 50-percent or greater interest—The term "50-percent or greater interest" has the meaning given such term by subsection (d)(4).

(B) Distributions in title 11 or similar case—Paragraph (1) shall not apply to any distribution made in a title 11 or similar case (as defined in section 368(a)(3)).

(C) Aggregation and attribution rules—

(i) Aggregation—The rules of paragraph (7)(A) of subsection (d) shall apply.

(ii) Attribution—Section 318(a)(2) shall apply in determining whether a person holds stock or securities in any corporation. Except as provided in regulations, section 318(a)(2)(C) shall be applied without regard to the phrase "50 percent or more in value" for purposes of the preceding sentence.

(D) Successors and predecessors—For purposes of this subsection, any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation.

(E) Statute of limitations—If there is a distribution to which paragraph (1) applies—

(i) the statutory period for the assessment of any deficiency attributable to any part of the gain recognized under this subsection by reason of such distribution shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) that such distribution occurred, and

(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(5) Regulations—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations—

(A) providing for the application of this subsection where there is more than 1 controlled corporation,

(B) treating 2 or more distributions as 1 distribution where necessary to prevent the avoidance of such purposes, and

(C) providing for the application of rules similar to the rules of subsection (d)(6) where appropriate for purposes of paragraph (2)(B).

(g) Section not to apply to distributions involving disqualified investment corporations

(1) In general—This section (and so much of section 356 as relates to this section) shall not apply to any distribution which is part of a transaction if—

(A) either the distributing corporation or controlled corporation is, immediately after the transaction, a disqualified investment corporation, and

(B) any person holds, immediately after the transaction, a 50-percent or greater interest in any disqualified investment corporation, but only if such person did not hold such an interest in such corporation immediately before the transaction.

(2) Disqualified investment corporation—For purposes of this subsection—

(A) In general—The term "disqualified investment corporation" means any distributing or controlled corporation if the fair market value of the investment assets of the corporation is—

(i) in the case of distributions after the end of the 1-year period beginning on the date of the enactment of this subsection, ■ or more of the fair market value of all assets of the corporation, and

(ii) in the case of distributions during such 1-year period, ¾ or more of the fair market value of all assets of the corporation.

(B) Investment assets—

(i) In general—Except as otherwise provided in this subparagraph, the term "investment assets" means—

(I) cash,

(II) any stock or securities in a corporation,

(III) any interest in a partnership,

(IV) any debt instrument or other evidence of indebtedness,

(V) any option, forward or futures contract, notional principal contract, or derivative,

(VI) foreign currency, or

(VII) any similar asset.

(ii) Exception for assets used in active conduct of certain financial trades or businesses—Such term shall not include any asset which is held for use in the active and regular conduct of—

(I) a lending or finance business (within the meaning of section 954(h)(4)),

(II) a banking business through a bank (as defined in section 581), a domestic building and loan association (within the meaning of section 7701(a)(19)), or any similar institution specified by the Secretary, or

(III) an insurance business if the conduct of the business is licensed, authorized, or regulated by an applicable insurance regulatory body.

This clause shall only apply with respect to any business if substantially all of the income of the business is derived from persons who are not related (within the meaning of section 267(b) or 707(b)(1)) to the person conducting the business.

(iii) Exception for securities marked to market—Such term shall not include any security (as defined in section 475(c)(2)) which is held by a dealer in securities and to which section 475(a) applies.

(iv) Stock or securities in a 20-percent controlled entity—

(I) In general—Such term shall not include any stock and securities in, or any asset described in subclause (IV) or (V) of clause (i) issued by, a corporation which is a 20-percent controlled entity with respect to the distributing or controlled corporation.

(II) Look-thru rule—The distributing or controlled corporation shall, for purposes of applying this subsection, be treated as owning its ratable share of the assets of any 20-percent controlled entity.

(III) 20-percent controlled entity—For purposes of this clause, the term "20-percent controlled entity" means, with respect to any distributing or controlled corporation, any corporation with respect to which the distributing or controlled corporation owns directly or indirectly stock meeting the requirements of section 1504(a)(2), except that such section shall be applied by substituting "20 percent" for "80 percent" and without regard to stock described in section 1504(a)(4).

(v) Interests in certain partnerships—

(I) In general—Such term shall not include any interest in a partnership, or any debt instrument or other evidence of indebtedness, issued by the partnership, if 1 or more of the trades or businesses of the partnership are (or, without regard to the 5-year requirement under subsection (b)(2)(B), would be) taken into account by the distributing or controlled corporation, as the case may be, in determining whether the requirements of subsection (b) are met with respect to the distribution.

(II) Look-thru rule—The distributing or controlled corporation shall, for purposes of applying this subsection, be treated as owning its ratable share of the assets of any partnership described in subclause (I).

(3) 50-percent or greater interest—For purposes of this subsection—

(A) In general—The term "50-percent or greater interest" has the meaning given such term by subsection (d)(4).

(B) Attribution rules—The rules of section 318 shall apply for purposes of determining ownership of stock for purposes of this paragraph.

(4) Transaction—For purposes of this subsection, the term "transaction" includes a series of transactions.

(5) Regulations—The Secretary shall prescribe such regulations as may be necessary to carry out, or prevent the avoidance of, the purposes of this subsection, including regulations—

(A) to carry out, or prevent the avoidance of, the purposes of this subsection in cases involving—

(i) the use of related persons, intermediaries, pass-thru entities, options, or other arrangements, and

(ii) the treatment of assets unrelated to the trade or business of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such unrelated assets,

(B) which in appropriate cases exclude from the application of this subsection a distribution which does not have the character of a redemption which would be treated as a sale or exchange under section 302, and

(C) which modify the application of the attribution rules applied for purposes of this subsection.

§356. RECEIPT OF ADDITIONAL CONSIDERATION

(a) Gain on exchanges

(1) Recognition of gain—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) Treatment as dividend—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) Additional consideration received in certain distributions

If—

(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) Loss

If—

(1) section 354 would apply to an exchange or section 355 would apply to an exchange or distribution, but for the fact that

(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

(d) Securities as other property

For purposes of this section—

(1) In general—Except as provided in paragraph (2), the term "other property" includes securities.

(2) Exceptions—

(A) Securities with respect to which nonrecognition of gain would be permitted—The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) Greater principal amount in section 354 exchange—If—

(i) in an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) Greater principal amount in section 355 transaction—If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

(e) Nonqualified preferred stock treated as other property

For purposes of this section—

(1) In general—Except as provided in paragraph (2), the term "other property" includes nonqualified preferred stock (as defined in section 351(g)(2)).

(2) Exception—The term "other property" does not include nonqualified preferred stock (as so defined) to the extent that, under section 354 or 355, such preferred stock would be permitted to be received without the recognition of gain.

(f) Exchanges for section 306 stock

Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies.

(g) Transactions involving gift or compensation

For special rules for a transaction described in section 354, 355, or this section, but which—

(1) results in a gift, see section 2501 and following, or

(2) has the effect of the payment of compensation, see section 61(a)(1).

§357. ASSUMPTION OF LIABILITY

(a) General rule

Except as provided in subsections (b) and (c), if—

(1) the taxpayer receives property which would be permitted to be received under section 351 or 361 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer,

then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 or 361, as the case may be.

(b) Tax avoidance purpose

(1) In general—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of proof—In any suit or proceeding where the burden is on the taxpayer to prove such assumption is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) Liabilities in excess of basis

(1) In general—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D) with respect to which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 355,

if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions—Paragraph (1) shall not apply to any exchange—

(A) to which subsection (b)(1) of this section applies, or

(B) which is pursuant to a plan of reorganization within the meaning of section 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock.

(3) Certain liabilities excluded—

(A) In general—If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either—

(i) would give rise to a deduction, or

(ii) would be described in section 736(a),

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

(B) Exception—Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

§358. BASIS TO DISTRIBUTEES

(a) General rule

In the case of an exchange to which section 351, 354, 355, 356, or 361 applies—

(1) Nonrecognition property—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) Other property—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

(b) Allocation of basis

(1) In general—Under regulations prescribed by the Secretary, the basis determined under subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

(2) Special rule for section 355—In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

(d) Assumption of liability

(1) In general—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(2) Exception—Paragraph (1) shall not apply to the amount of any liability excluded under section 357(c)(3).

(e) Exception

This section shall not apply to property acquired by a corporation by the exchange of its stock or securities (or the stock or securities of a corporation which is in control of the acquiring corporation) as consideration in whole or in part for the transfer of the property to it.

(f) Definition of nonrecognition property in case of section 361 exchange

For purposes of this section, the property permitted to be received under section 361 without the recognition of gain or loss shall be treated as consisting only of stock or securities in another corporation a party to the reorganization.

(h) Special rules for assumption of liabilities to which subsection (d) does not apply

(1) In general—If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a)(1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability—

(A) which is assumed by another person as part of the exchange, and

(B) with respect to which subsection (d)(1) does not apply to the assumption.

(2) Exceptions—Except as provided by the Secretary, paragraph (1) shall not apply to any liability if—

(A) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or

(B) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.

(3) Liability—For purposes of this subsection, the term "liability" shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title.

§361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS; TREATMENT OF DISTRIBUTIONS

(a) General rule

No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) Exchanges not solely in kind

(1) Gain—If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then—

(A) Property distributed—If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) Property not distributed—If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized.

The amount of gain recognized under subparagraph (B) shall not exceed the sum of the money and the fair market value of the other property so received which is not so distributed.

(2) Loss—If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(3) Treatment of transfers to creditors—For purposes of paragraph (1), any transfer of the other property or money received in the exchange by the corporation to its creditors in connection with the reorganization shall be treated as a distribution in pursuance of the plan of reorganization. The Secretary may prescribe such regulations as may be necessary to prevent avoidance of tax through abuse of the preceding sentence or subsection (c)(3). In the case of a reorganization described in section 368(a)(1)(D) with respect to which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 355, this paragraph shall apply only to the extent that the sum of the money and the fair market value of other property transferred to such creditors does not exceed the adjusted bases of such assets transferred (reduced by the amount of the liabilities assumed (within the meaning of section 357(c))).

(c) Treatment of distributions

(1) In general—Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization.

(2) Distributions of appreciated property—

(A) In general—If—

(i) in a distribution referred to in paragraph (1), the corporation distributes property other than qualified property, and

(ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(B) Qualified property—For purposes of this subsection, the term "qualified property" means—

(i) any stock in (or right to acquire stock in) the distributing corporation or obligation of the distributing corporation, or

(ii) any stock in (or right to acquire stock in) another corporation which is a party to the reorganization or obligation of another corporation which is such a party if such stock (or right) or obligation is received by the distributing corporation in the exchange.

(C) Treatment of liabilities—If any property distributed in the distribution referred to in paragraph (1) is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, then, for purposes of subparagraph (A), the fair market value of such property shall be treated as not less than the amount of such liability.

(3) Treatment of certain transfers to creditors—For purposes of this subsection, any transfer of qualified property by the corporation to its creditors in connection with the reorganization shall be treated as a distribution to its shareholders pursuant to the plan of reorganization.

(4) Coordination with other provisions—Section 311 and subpart B of part II of this subchapter shall not apply to any distribution referred to in paragraph (1).

(5) Cross reference—For provision providing for recognition of gain in certain distributions, see section 355(d).

§362. BASIS TO CORPORATIONS

(a) Property acquired by issuance of stock or as paid-in surplus

If property was acquired by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) Transfers to corporations

If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

(c) Special rule for certain contributions to capital

(1) Property other than money—Notwithstanding subsection (a)(2), if property other than money—

(A) is acquired by a corporation as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of such property shall be zero.

(2) Money—Notwithstanding subsection (a)(2), if money—

(A) is received by a corporation as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary.

(d) Limitation on basis increase attributable to assumption of liability

(1) In general—In no event shall the basis of any property be increased under subsection (a) or (b) above the fair market value of such property (determined without regard to section 7701(g)) by reason of any gain recognized to the transferor as a result of the assumption of a liability.

(2) Treatment of gain not subject to tax—Except as provided in regulations, if—

(A) gain is recognized to the transferor as a result of an assumption of a nonrecourse liability by a transferee which is also secured by assets not transferred to such transferee; and

(B) no person is subject to tax under this title on such gain,

then, for purposes of determining basis under subsections (a) and (b), the amount of gain recognized by the transferor as a result of the assumption of the liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of such liability determined on the basis of the relative fair market values (determined without regard to section 7701(g)) of all of the assets subject to such liability.

(e) Limitations on built-in losses

(1) Limitation on importation of built-in losses—

(A) In general—If in any transaction described in subsection (a) or (b) there would (but for this subsection) be an importation of a net built-in loss, the basis of each property described in subparagraph (B) which is acquired in such transaction shall (notwithstanding subsections (a) and (b)) be its fair market value immediately after such transaction.

(B) Property described—For purposes of subparagraph (A), property is described in this subparagraph if—

(i) gain or loss with respect to such property is not subject to tax under this subtitle in the hands of the transferor immediately before the transfer, and

(ii) gain or loss with respect to such property is subject to such tax in the hands of the transferee immediately after such transfer.

In any case in which the transferor is a partnership, the preceding sentence shall be applied by treating each partner in such partnership as holding such partner's proportionate share of the property of such partnership.

(C) Importation of net built-in loss—For purposes of subparagraph (A), there is an importation of a net built-in loss in a transaction if the transferee's aggregate adjusted bases of property described in subparagraph (B) which is transferred in such transaction would (but for this paragraph) exceed the fair market value of such property immediately after such transaction.

(2) Limitation on transfer of built-in losses in section 351 transactions—

(A) In general—If—

(i) property is transferred by a transferor in any transaction which is described in subsection (a) and which is not described in paragraph (1) of this subsection, and

(ii) the transferee's aggregate adjusted bases of such property so transferred would (but for this paragraph) exceed the fair market value of such property immediately after such transaction,

then, notwithstanding subsection (a), the transferee's aggregate adjusted bases of the property so transferred shall not exceed the fair market value of such property immediately after such transaction.

(B) Allocation of basis reduction—The aggregate reduction in basis by reason of subparagraph (A) shall be allocated among the property so transferred in proportion to their respective built-in losses immediately before the transaction.

(C) Election to apply limitation to transferor's stock basis—

(i) In general—If the transferor and transferee of a transaction described in subparagraph (A) both elect the application of this subparagraph—

(I) subparagraph (A) shall not apply, and

(II) the transferor's basis in the stock received for property to which subparagraph (A) does not apply by reason of the election shall not exceed its fair market value immediately after the transfer.

(ii) Election—Any election under clause (i) shall be made at such time and in such form and manner as the Secretary may prescribe, and, once made, shall be irrevocable.

§368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS

(a) Reorganization

(1) In general—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be

disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization;

(F) a mere change in identity, form, or place of organization of one corporation, however effected; or

(G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

(2) Special rules relating to paragraph (1)

(A) Reorganizations described in both paragraph (1)(C) and paragraph (1)(D) If a transaction is described in both paragraph (1)(C) and paragraph (1)(D), then, for purposes of this subchapter (other than for purposes of subparagraph (C)), such transaction shall be treated as described only in paragraph (1)(D).

(B) Additional consideration in certain paragraph (1)(C) cases—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1)(C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1)(C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation shall be treated as money paid for the property.

(C) Transfers of assets or stock to subsidiaries in certain paragraph (1)(A), (1)(B), (1)(C), and (1)(G) cases—A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock. A similar rule shall apply to a transaction otherwise qualifying under paragraph (1)(G) where the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met with respect to the acquisition of the assets.

(D) Use of stock of controlling corporation in paragraph (1)(A) and (1)(G) cases—The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1)(A) or (1)(G) if—

(i) no stock of the acquiring corporation is used in the transaction, and

(ii) in the case of a transaction under paragraph (1)(A), such transaction would have qualified under paragraph (1)(A) had the merger been into the controlling corporation.

(E) Statutory merger using voting stock of corporation controlling merged corporation—A transaction otherwise qualifying under paragraph (1)(A) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if—

(i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and

(ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

(F) Certain transactions involving 2 or more investment companies—

(i) If immediately before a transaction described in paragraph (1) (other than subparagraph (E) thereof), 2 or more parties to the transaction were investment companies, then the transaction shall not be considered to be a reorganization with respect to any such investment company (and its shareholders and security holders) unless it was a regulated investment company, a real estate investment trust, or a corporation which meets the requirements of clause (ii).

(ii) A corporation meets the requirements of this clause if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer, and not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers. For purposes of this clause, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. For purposes of this clause, a person holding stock in a regulated investment company, a real estate investment trust, or an investment company which meets the requirements of this clause shall, except as provided in regulations, be treated as holding its proportionate share of the assets held by such company or trust.

(iii) For purposes of this subparagraph the term "investment company" means a regulated investment company, a real estate investment trust, or a corporation 50 percent or more of the value of whose total assets are stock and securities and 80 percent or more of the value of whose total assets are assets held for investment. In making the 50-percent and 80-percent determinations under the preceding sentence, stock and securities in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and a corporation shall be considered a subsidiary if the parent owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of shares of all classes of stock outstanding.

(iv) For purposes of this subparagraph, in determining total assets there shall be excluded cash and cash items (including receivables). Government securities, and, under regulations prescribed by the Secretary, assets acquired (through incurring indebtedness or otherwise) for purposes of meeting the requirements of clause (ii) or ceasing to be an investment company.

(v) This subparagraph shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions.

(vi) If an investment company which does not meet the requirements of clause (ii) acquires assets of another corporation, clause (i) shall be applied to such investment company and its shareholders and security holders as though its assets had been acquired by such other corporation. If such investment

company acquires stock of another corporation in a reorganization described in section 368(a)(1)(B), clause (i) shall be applied to the shareholders of such investment company as though they had exchanged with such other corporation all of their stock in such company for stock having a fair market value equal to the fair market value of their stock of such investment company immediately after the exchange. For purposes of section 1001, the deemed acquisition or exchange referred to in the two preceding sentences shall be treated as a sale or exchange of property by the corporation and by the shareholders and security holders to which clause (i) is applied.

(vii) For purposes of clauses (ii) and (iii), the term "securities" includes obligations of State and local governments, commodity futures contracts, shares of regulated investment companies and real estate investment trusts, and other investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(36)).

[(viii) Repealed. Pub. L. 98–369, div. A, title I, §174(b)(5)(D), July 18, 1984, 98 Stat. 707]

(G) Distribution requirement for paragraph (1)(C)

(i) In general—A transaction shall fail to meet the requirements of paragraph (1)(C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization. For purposes of the preceding sentence, if the acquired corporation is liquidated pursuant to the plan of reorganization, any distribution to its creditors in connection with such liquidation shall be treated as pursuant to the plan of reorganization.

(ii) Exception—The Secretary may waive the application of clause (i) to any transaction subject to any conditions the Secretary may prescribe.

(H) Special rules for determining whether certain transactions are qualified under paragraph (1)(D) For purposes of determining whether a transaction qualifies under paragraph (1)(D)—

(i) in the case of a transaction with respect to which the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, the term "control" has the meaning given such term by section 304(c), and

(ii) in the case of a transaction with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account.

(3) Additional rules relating to title 11 and similar cases—

(A) Title 11 or similar case defined—For purposes of this part, the term "title 11 or similar case" means—

(i) a case under title 11 of the United States Code, or

(ii) a receivership, foreclosure, or similar proceeding in a Federal or State court.

(B) Transfer of assets in a title 11 or similar case—In applying paragraph (1)(G), a transfer of the assets of a corporation shall be treated as made in a title 11 or similar case if and only if—

(i) any party to the reorganization is under the jurisdiction of the court in such case, and

(ii) the transfer is pursuant to a plan of reorganization approved by the court.

(C) Reorganizations qualifying under paragraph (1)(G) and another provision—If a transaction would (but for this subparagraph) qualify both—

(i) under subparagraph (G) of paragraph (1), and

(ii) under any other subparagraph of paragraph (1) or under section 332 or 351,

then, for purposes of this subchapter (other than section 357(c)(1)), such transaction shall be treated as qualifying only under subparagraph (G) of paragraph (1).

(D) Agency receivership proceedings which involve financial institutions—For purposes of subparagraphs (A) and (B), in the case of a receivership, foreclosure, or similar proceeding before a Federal or State agency involving a financial institution referred to in section 581 or 591, the agency shall be treated as a court.

(E) Application of paragraph (2)(E)(ii) In the case of a title 11 or similar case, the requirement of clause (ii) of paragraph (2)(E) shall be treated as met if—

(i) no former shareholder of the surviving corporation received any consideration for his stock, and

(ii) the former creditors of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, debt of the surviving corporation which had a fair market value equal to 80 percent or more of the total fair market value of the debt of the surviving corporation.

(b) Party to a reorganization

For purposes of this part, the term "a party to a reorganization" includes—

(1) a corporation resulting from a reorganization, and

(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1)(B) or (1)(C) of subsection (a), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), (1)(C), or (1)(G) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred. In the case of a reorganization qualifying under paragraph (1)(A) or (1)(G) of subsection (a) by reason of paragraph (2)(D) of that subsection, the term "a party to a reorganization" includes the controlling corporation referred to in such paragraph (2)(D). In the case of a reorganization qualifying under subsection (a)(1)(A) by reason of subsection (a)(2)(E), the term "party to a reorganization" includes the controlling corporation referred to in subsection (a)(2)(E).

(c) Control defined

For purposes of part I (other than section 304), part II, this part, and part V, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

§381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS

(a) General rule

In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies; or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c). For purposes of the preceding sentence, a reorganization shall be treated as meeting the requirements of subparagraph (D) or (G) of section 368(a)(1) only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met.

(c) Items of the distributor or transferor corporation

The items referred to in subsection (a) are:

(1) Net operating loss carryovers—The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For the purpose of determining the amount of the net operating loss carryovers under section 172(b)(2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section 172(b)(2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—

(i) such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");

(ii) the pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) the post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;

(iv) the taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;

(v) the net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172(b)(2)(B),1 but without regard to a net operating loss year of the distributor or transferor corporation; and

(vi) the net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172(b)(2)(B).[1]

(2) Earnings and profits—In the case of a distribution or transfer described in subsection (a)—

(A) the earnings and profits or deficit in earnings and profits, as the case may be, of the distributor or transferor corporation shall, subject to subparagraph (B), be deemed to have been received or incurred by the acquiring corporation as of the close of the date of the distribution or transfer; and

(B) a deficit in earnings and profits of the distributor, transferor, or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs shall be deemed to have been accumulated after such distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of the acquiring corporation for such taxable year (computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A) of this paragraph) as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(3) Capital loss carryover—The capital loss carryover determined under section 1212, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the capital loss carryover of the distributor or transferor corporation is first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) The capital loss carryover shall be a short-term capital loss in the taxable year determined under subparagraph (A) but shall be limited to an amount which bears the same ratio to the capital gain net income (determined without regard to a short-term capital loss attributable to capital loss carryover), if any, of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For purposes of determining the amount of such capital loss carryover to taxable years following the taxable year determined under subparagraph (A), the capital gain net income in the taxable year determined under subparagraph (A) shall be considered to be an amount equal to the amount determined under subparagraph (B).

(4) Method of accounting—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

(5) Inventories—In any case in which inventories are received by the acquiring corporation, such inventories shall be taken by such corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation, unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventory adopted pursuant to regulations prescribed by the Secretary.

(6) Method of computing depreciation allowance—The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under sections 167 and 168 on property acquired in a distribution or transfer with respect to so much of the basis in the hands of the acquiring corporation as does not exceed the adjusted basis in the hands of the distributor or transferor corporation.

[(7) Repealed. June 15, 1955, ch. 143, §2(1), 69 Stat. 134]—

(8) Installment method—If the acquiring corporation acquires installment obligations (the income from which the distributor or transferor corporation reports on the installment basis under section 453) the acquiring corporation shall, for purposes of section 453, be treated as if it were the distributor or transferor corporation.

(9) Amortization of bond discount or premium—If the acquiring corporation assumes liability for bonds of the distributor or transferor corporation issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable or includible with respect to such discount or premium.

(10) Treatment of certain mining development and exploration expenses of distributor or transferor corporation—The acquiring corporation shall be entitled to deduct, as if it were the distributor or transferor corporation, expenses deferred under section 616 (relating to certain development expenditures) if the distributor or transferor corporation has so elected.

(11) Contributions to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans—The acquiring corporation shall be considered to be the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the amounts deductible under section 404 with respect to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans.

(12) Recovery of tax benefit items—If the acquiring corporation is entitled to the recovery of any amounts previously deducted by (or allowable as credits to) the distributor or transferor corporation, the acquiring corporation shall succeed to the treatment under section 111 which would apply to such amounts in the hands of the distributor or transferor corporation.

(13) Involuntary conversions under section 1033—The acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of applying section 1033.

(14) Dividend carryover to personal holding company—The dividend carryover (described in section 564) to taxable years ending after the date of distribution or transfer.

[(15) Repealed. Pub. L. 101–508, title XI, §11801(c)(10)(A), Nov. 5, 1990, 104 Stat. 1388–526]—

(16) Certain obligations of distributor or transferor corporation—If the acquiring corporation—

> **(A)** assumes an obligation of the distributor or transferor corporation which, after the date of the distribution or transfer, gives rise to a liability, and
>
> **(B)** such liability, if paid or accrued by the distributor or transferor corporation, would have been deductible in computing its taxable income,

the acquiring corporation shall be entitled to deduct such items when paid or accrued, as the case may be, as if such corporation were the distributor or transferor corporation. This paragraph shall not apply if such obligations are reflected in the amount of stock, securities, or property transferred by the acquiring corporation

to the transferor corporation for the property of the transferor corporation.

(17) Deficiency dividend of personal holding company—If the acquiring corporation pays a deficiency dividend (as defined in section 547(d)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 547.

(18) Percentage depletion on extraction of ores or minerals from the waste or residue of prior mining—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 613(c)(3) (relating to extraction of ores or minerals from the ground).

(19) Charitable contributions in excess of prior years' limitations—Contributions made in the taxable year ending on the date of distribution or transfer and the 4 prior taxable years by the distributor or transferor corporation in excess of the amount deductible under section 170(b)(2) for such taxable years shall be deductible by the acquiring corporation for its taxable years which begin after the date of distribution or transfer, subject to the limitations imposed in section 170(b)(2). In applying the preceding sentence, each taxable year of the distributor or transferor corporation beginning on or before the date of distribution or transfer shall be treated as a prior taxable year with reference to the acquiring corporation's taxable years beginning after such date.

(20) Carryforward of disallowed business interest—The carryover of disallowed business interest described in section 163(j)(2) to taxable years ending after the date of distribution or transfer.

[(21) Repealed. Pub. L. 94–455, title XIX, §1901(b)(16), Oct. 4, 1976, 90 Stat. 1796]—

(22) Successor insurance company—If the acquiring corporation is an insurance company taxable under subchapter L, there shall be taken into account (to the extent proper to carry out the purposes of this section and of subchapter L, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of subchapter L in respect of the distributor or transferor corporation.

(23) Deficiency dividend of regulated investment company or real estate investment trust—If the acquiring corporation pays a deficiency dividend (as defined in section 860(f)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 860.

(24) Credit under section 38—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation.

(25) Credit under section 53—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 53, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 53 in respect of the distributor or transferor corporation.

(26) Enterprise zone provisions—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and subchapter U, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of subchapter U in respect of the distributor or transferor corporation.

§382. LIMITATION ON NET OPERATING LOSS CARRYFORWARDS AND CERTAIN BUILT-IN LOSSES FOLLOWING OWNERSHIP CHANGE

(a) General rule

The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year.

(b) Section 382 limitation

For purposes of this section—

(1) In general—Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to—

(A) the value of the old loss corporation, multiplied by

(B) the long-term tax-exempt rate.

(2) Carryforward of unused limitation—If the section 382 limitation for any post-change year exceeds the taxable income of the new loss corporation for such year which was offset by pre-change losses, the section 382 limitation for the next post-change year shall be increased by the amount of such excess.

(3) Special rule for post-change year which includes change date—In the case of any post-change year which includes the change date—

(A) Limitation does not apply to taxable income before change—Subsection (a) shall not apply to the portion of the taxable income for such year which is allocable to the period in such year on or before the change date. Except as provided in subsection (h)(5) and in regulations, taxable income shall be allocated ratably to each day in the year.

(B) Limitation for period after change—For purposes of applying the limitation of subsection (a) to the remainder of the taxable income for such year, the section 382 limitation shall be an amount which bears the same ratio to such limitation (determined without regard to this paragraph) as—

(i) the number of days in such year after the change date, bears to

(ii) the total number of days in such year.

(c) Carryforwards disallowed if continuity of business requirements not met

(1) In general—Except as provided in paragraph (2), if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero.

(2) Exception for certain gains—The section 382 limitation for any post-change year shall not be less than the sum of—

(A) any increase in such limitation under—

(i) subsection (h)(1)(A) for recognized built-in gains for such year, and

(ii) subsection (h)(1)(C) for gain recognized by reason of an election under section 338, plus

(B) any increase in such limitation under subsection (b)(2) for amounts described in subparagraph (A) which are carried forward to such year.

(d) Pre-change loss and post-change year

For purposes of this section—

(1) Pre-change loss—The term "pre-change loss" means—

(A) any net operating loss carryforward of the old loss corporation to the taxable year ending with the ownership change or in which the change date occurs, and

(B) the net operating loss of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before the change date.

Except as provided in subsection (h)(5) and in regulations, the net operating loss shall, for purposes of subparagraph (B), be allocated ratably to each day in the year.

(2) Post-change year—The term "post-change year" means any taxable year ending after the change date.

(3) Application to carryforward of disallowed interest—The term "pre-change loss" shall include any carryover of disallowed interest described in section 163(j)(2) under rules similar to the rules of paragraph (1).

(e) Value of old loss corporation

For purposes of this section—

(1) In general—Except as otherwise provided in this subsection, the value of the old loss corporation is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the ownership change.

(2) Special rule in the case of redemption or other corporate contraction—If a redemption or other corporate contraction occurs in connection with an ownership change, the value under paragraph (1) shall be determined after taking such redemption or other corporate contraction into account.

(3) Treatment of foreign corporations—Except as otherwise provided in regulations, in determining the value of any old loss corporation which is a foreign corporation, there shall be taken into account only items treated as connected with the conduct of a trade or business in the United States.

(f) Long-term tax-exempt rate

For purposes of this section—

(1) In general—The long-term tax-exempt rate shall be the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs.

(2) Adjusted Federal long-term rate—For purposes of paragraph (1), the term "adjusted Federal long-term rate" means the Federal long-term rate determined under section 1274(d), except that—

(A) paragraphs (2) and (3) thereof shall not apply, and

(B) such rate shall be properly adjusted for differences between rates on long-term taxable and tax-exempt obligations.

(g) Ownership change

For purposes of this section—

(1) In general—There is an ownership change if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift—

(A) the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over

(B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.

(2) Owner shift involving 5-percent shareholder—There is an owner shift involving a 5-percent shareholder if—

(A) there is any change in the respective ownership of stock of a corporation, and

(B) such change affects the percentage of stock of such corporation owned by any person who is a 5-percent shareholder before or after such change.

(3) Equity structure shift defined—

(A) In general—The term "equity structure shift" means any reorganization (within the meaning of section 368). Such term shall not include—

(i) any reorganization described in subparagraph (D) or (G) of section 368(a)(1) unless the requirements of section 354(b)(1) are met, and

(ii) any reorganization described in subparagraph (F) of section 368(a)(1).

(B) Taxable reorganization-type transactions, etc.—To the extent provided in regulations, the term "equity structure shift" includes taxable reorganization-type transactions, public offerings, and similar transactions.

(4) Special rules for application of subsection—

(A) Treatment of less than 5-percent shareholders—Except as provided in subparagraphs (B)(i) and (C), in determining whether an ownership change has occurred, all stock owned by shareholders of a corporation who are not 5-percent shareholders of such corporation shall be treated as stock owned by 1 5-percent shareholder of such corporation.

(B) Coordination with equity structure shifts—For purposes of determining whether an equity structure shift (or subsequent transaction) is an ownership change—

(i) Less than 5-percent shareholders—Subparagraph (A) shall be applied separately with respect to each group of shareholders (immediately before such equity structure shift) of each corporation which was a party to the reorganization involved in such equity structure shift.

(ii) Acquisitions of stock—Unless a different proportion is established, acquisitions of stock after such equity structure shift shall be treated as being made proportionately from all shareholders immediately before such acquisition.

(C) Coordination with other owner shifts—Except as provided in regulations, rules similar to the rules of subparagraph (B) shall apply in determining whether there has been an owner shift involving a 5-percent shareholder and whether such shift (or subsequent transaction) results in an ownership change.

(D) Treatment of worthless stock—If any stock held by a 50-percent shareholder is treated by such shareholder as becoming worthless during any taxable year of such shareholder and such stock is held by such shareholder as of the close of such taxable year, for purposes of determining whether an ownership change occurs after the close of such taxable year, such shareholder—

(i) shall be treated as having acquired such stock on the 1st day of his 1st succeeding taxable year, and

(ii) shall not be treated as having owned such stock during any prior period.

For purposes of the preceding sentence, the term "50-percent shareholder" means any person owning 50 percent or more of the stock of the corporation at any time during the 3-year period ending on the last day of the taxable year with respect to which the stock was so treated.

(h) Special rules for built-in gains and losses and section 338 gains

For purposes of this section—

(1) In general—

(A) Net unrealized built-in gain—

(i) In general—If the old loss corporation has a net unrealized built-in gain, the section 382 limitation for any recognition period taxable year shall be increased by the recognized built-in gains for such taxable year.

(ii) Limitation—The increase under clause (i) for any recognition period taxable year shall not exceed—

(I) the net unrealized built-in gain, reduced by

(II) recognized built-in gains for prior years ending in the recognition period.

(B) Net unrealized built-in loss—

(i) In general—If the old loss corporation has a net unrealized built-in loss, the recognized built-in loss for any recognition period taxable year shall be subject to limitation under this section in the same manner as if such loss were a pre-change loss.

(ii) Limitation—Clause (i) shall apply to recognized built-in losses for any recognition period taxable year only to the extent such losses do not exceed—

(I) the net unrealized built-in loss, reduced by

(II) recognized built-in losses for prior taxable years ending in the recognition period.

(C) Special rules for certain section 338 gains—If an election under section 338 is made in connection with an ownership change and the net unrealized built-in gain is zero by reason of paragraph (3)(B), then,

with respect to such change, the section 382 limitation for the post-change year in which gain is recognized by reason of such election shall be increased by the lesser of—

(i) the recognized built-in gains by reason of such election, or

(ii) the net unrealized built-in gain (determined without regard to paragraph (3)(B)).

(2) Recognized built-in gain and loss—

(A) Recognized built-in gain—The term "recognized built-in gain" means any gain recognized during the recognition period on the disposition of any asset to the extent the new loss corporation establishes that—

(i) such asset was held by the old loss corporation immediately before the change date, and

(ii) such gain does not exceed the excess of—

(I) the fair market value of such asset on the change date, over

(II) the adjusted basis of such asset on such date.

(B) Recognized built-in loss—The term "recognized built-in loss" means any loss recognized during the recognition period on the disposition of any asset except to the extent the new loss corporation establishes that—

(i) such asset was not held by the old loss corporation immediately before the change date, or

(ii) such loss exceeds the excess of—

(I) the adjusted basis of such asset on the change date, over

(II) the fair market value of such asset on such date.

Such term includes any amount allowable as depreciation, amortization, or depletion for any period within the recognition period except to the extent the new loss corporation establishes that the amount so allowable is not attributable to the excess described in clause (ii).

(3) Net unrealized built-in gain and loss defined—

(A) Net unrealized built-in gain and loss—

(i) In general—The terms "net unrealized built-in gain" and "net unrealized built-in loss" mean, with respect to any old loss corporation, the amount by which—

(I) the fair market value of the assets of such corporation immediately before an ownership change is more or less, respectively, than

(II) the aggregate adjusted basis of such assets at such time.

(ii) Special rule for redemptions or other corporate contractions—If a redemption or other corporate contraction occurs in connection with an ownership change, to the extent provided in regulations, determinations under clause (i) shall be made after taking such redemption or other corporate contraction into account.

(B) Threshold requirement—

(i) In general—If the amount of the net unrealized built-in gain or net unrealized built-in loss (determined without regard to this subparagraph) of any old loss corporation is not greater than the lesser of—

(I) 15 percent of the amount determined for purposes of subparagraph (A)(i)(I), or

(II) $10,000,000,

the net unrealized built-in gain or net unrealized built-in loss shall be zero.

(ii) Cash and cash items not taken into account—In computing any net unrealized built-in gain or net unrealized built-in loss under clause (i), except as provided in regulations, there shall not be taken into account—

(I) any cash or cash item, or

(II) any marketable security which has a value which does not substantially differ from adjusted basis.

(4) Disallowed loss allowed as a carryforward—If a deduction for any portion of a recognized built-in loss is disallowed for any post-change year, such portion—

(A) shall be carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of net operating losses (or to the extent the amount so disallowed is attributable to capital losses, under rules similar to the rules for the carrying forward of net capital losses), but

(B) shall be subject to limitation under this section in the same manner as a pre-change loss.

(5) Special rules for post-change year which includes change date—For purposes of subsection (b)(3)—

(A) in applying subparagraph (A) thereof, taxable income shall be computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year (or recognized built-in losses to the extent such losses are treated as pre-change losses), and gain described in paragraph (1)(C), for the year, and

(B) in applying subparagraph (B) thereof, the section 382 limitation shall be computed without regard to recognized built-in gains, and gain described in paragraph (1)(C), for the year.

(6) Treatment of certain built-in items—

(A) Income items—Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.

(B) Deduction items—Any amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction.

(C) Adjustments—The amount of the net unrealized built-in gain or loss shall be properly adjusted for amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period.

(7) Recognition period, etc.—

(A) Recognition period—The term "recognition period" means, with respect to any ownership change, the 5-year period beginning on the change date.

(B) Recognition period taxable year—The term "recognition period taxable year" means any taxable year any portion of which is in the recognition period.

(8) Determination of fair market value in certain cases—If 80 percent or more in value of the stock of a corporation is acquired in 1 transaction (or in a series of related transactions during any 12-month period), for purposes of determining the net unrealized built-in loss, the fair market value of the assets of such corporation shall not exceed the grossed up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items.

(9) Tax-free exchanges or transfers—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection where property held on the change date was acquired (or is subsequently transferred) in a transaction where gain or loss is not recognized (in whole or in part).

(i) Testing period

For purposes of this section—

(1) 3-year period—Except as otherwise provided in this section, the testing period is the 3-year period ending on the day of any owner shift involving a 5-percent shareholder or equity structure shift.

(2) Shorter period where there has been recent ownership change—If there has been an ownership change under this section, the testing period for determining whether a 2nd ownership change has occurred shall not begin before the 1st day following the change date for such earlier ownership change.

(3) Shorter period where all losses arise after 3-year period begins—The testing period shall not begin before the earlier of the 1st day of the 1st taxable year from which there is a carryforward of a loss or of an excess credit to the 1st post-change year or the taxable year in which the transaction being tested occurs. Except as provided in regulations, this paragraph shall not apply to any loss corporation which has a net unrealized built-in loss (determined after application of subsection (h)(3)(B)).

(j) Change date

For purposes of this section, the change date is—

(1) in the case where the last component of an ownership change is an owner shift involving a 5-percent shareholder, the date on which such shift occurs, and

(2) in the case where the last component of an ownership change is an equity structure shift, the date of the reorganization.

(k) Definitions and special rules

For purposes of this section—

(1) Loss corporation—The term "loss corporation" means a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Such term shall include any corporation entitled to use a carryforward of disallowed interest described in section 381(c)(20). Except to the extent provided in regulations, such term includes any corporation with a net unrealized built-in loss.

(2) Old loss corporation—The term "old loss corporation" means any corporation—

(A) with respect to which there is an ownership change, and

(B) which (before the ownership change) was a loss corporation.

(3) New loss corporation—The term "new loss corporation" means a corporation which (after an ownership change) is a loss corporation. Nothing in this section shall be treated as implying that the same corporation may not be both the old loss corporation and the new loss corporation.

(4) Taxable income—Taxable income shall be computed with the modifications set forth in section 172(d).

(5) Value—The term "value" means fair market value.

(6) Rules relating to stock—

(A) Preferred stock—Except as provided in regulations and subsection (e), the term "stock" means stock other than stock described in section 1504(a)(4).

(B) Treatment of certain rights, etc.—The Secretary shall prescribe such regulations as may be necessary—

(i) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and

(ii) to treat stock as not stock.

(C) Determinations on basis of value—Determinations of the percentage of stock of any corporation held by any person shall be made on the basis of value.

(7) 5-percent shareholder—The term "5-percent shareholder" means any person holding 5 percent or more of the stock of the corporation at any time during the testing period.

§385. TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS

(a) Authority to prescribe regulations

The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

(b) Factors

The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

(c) Effect of classification by issuer

(1) In general—The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary).

(2) Notification of inconsistent treatment—Except as provided in regulations, paragraph (1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the characterization referred to in paragraph (1).

(3) Regulations—The Secretary is authorized to require such information as the Secretary determines to be necessary to carry out the provisions of this subsection.

§448. LIMITATION ON USE OF CASH METHOD OF ACCOUNTING

(a) General rule

Except as otherwise provided in this section, in the case of a—

(1) C corporation,

(2) partnership which has a C corporation as a partner, or

(3) tax shelter,

taxable income shall not be computed under the cash receipts and disbursements method of accounting.

(b) Exceptions

(1) Farming business—Paragraphs (1) and (2) of subsection (a) shall not apply to any farming business.

(2) Qualified personal service corporations—Paragraphs (1) and (2) of subsection (a) shall not apply to a qualified personal service corporation, and such a corporation shall be treated as an individual for purposes of determining whether paragraph (2) of subsection (a) applies to any partnership.

(3) Entities which meet gross receipts test—Paragraphs (1) and (2) of subsection (a) shall not apply to any corporation or partnership for any taxable year if such entity (or any predecessor) meets the gross receipts test of subsection (c) for such taxable year.

§482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of

any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

§531. IMPOSITION OF ACCUMULATED EARNINGS TAX

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of each corporation described in section 532, an accumulated earnings tax equal to 20 percent of the accumulated taxable income.

§532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX

(a) General rule

The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) Exceptions

The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542),

(2) a corporation exempt from tax under subchapter F (section 501 and following), or

(3) a passive foreign investment company (as defined in section 1297).

(c) Application determined without regard to number of shareholders

The application of this part to a corporation shall be determined without regard to the number of shareholders of such corporation.

§533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX

(a) Unreasonable accumulation determinative of purpose

For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) Holding or investment company

The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

§535. ACCUMULATED TAXABLE INCOME

(a) Definition

For purposes of this subtitle, the term “accumulated taxable income” means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) Adjustments to taxable income

For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) Taxes—There shall be allowed as a deduction Federal income and excess profits taxes and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 960 for the taxable year, but not including the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541.

(2) Charitable contributions—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) Special deductions disallowed—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) Net operating loss—The net operating loss deduction provided in section 172 shall not be allowed.

(5) Capital losses—

(A) In general—Except as provided in subparagraph (B), there shall be allowed as a deduction an amount equal to the net capital loss for the taxable year (determined without regard to paragraph (7)(A)).

(B) Recapture of previous deductions for capital gains—The aggregate amount allowable as a deduction under subparagraph (A) for any taxable year shall be reduced by the lesser of—

(i) the nonrecaptured capital gains deductions, or

(ii) the amount of the accumulated earnings and profits of the corporation as of the close of the preceding taxable year.

(C) Nonrecaptured capital gains deductions—For purposes of subparagraph (B), the term “nonrecaptured capital gains deductions” means the excess of—

(i) the aggregate amount allowable as a deduction under paragraph (6) for preceding taxable years beginning after July 18, 1984, over

(ii) the aggregate of the reductions under subparagraph (B) for preceding taxable years.

(6) Net capital gains—

(A) In general—There shall be allowed as a deduction—

(i) the net capital gain for the taxable year (determined with the application of paragraph (7)), reduced by

(ii) the taxes attributable to such net capital gain.

(B) Attributable taxes—For purposes of subparagraph (A), the taxes attributable to the net capital gain shall be an amount equal to the difference between—

(i) the taxes imposed by this subtitle (except the tax imposed by this part) for the taxable year, and

(ii) such taxes computed for such year without including in taxable income the net capital gain for the taxable year (determined without the application of paragraph (7)).

(7) Capital loss carryovers—

(A) Unlimited carryforward—The net capital loss for any taxable year shall be treated as a short-term capital loss in the next taxable year.

(B) Section 1212 inapplicable—No allowance shall be made for the capital loss carryback or carryforward provided in section 1212.

(8) Special rules for mere holding or investment companies—In the case of a mere holding or investment company—

(A) Capital loss deduction, etc., not allowed—Paragraphs (5) and (7)(A) shall not apply.

(B) Deduction for certain offsets—There shall be allowed as a deduction the net short-term capital gain for the taxable year to the extent such gain does not exceed the amount of any capital loss carryover to such taxable year under section 1212 (determined without regard to paragraph (7)(B)).

(C) Earnings and profits—For purposes of subchapter C, the accumulated earnings and profits at any time shall not be less than they would be if this subsection had applied to the computation of earnings and profits for all taxable years beginning after July 18, 1984.

(9) Special rule for capital gains and losses of foreign corporations—In the case of a foreign corporation, paragraph (6) shall be applied by taking into account only gains and losses which are effectively connected with the conduct of a trade or business within the United States and are not exempt from tax under treaty.

(10) Controlled foreign corporations—There shall be allowed as a deduction the amount of the corporation's income for the taxable year which is included in the gross income of a United States shareholder under section 951(a). In the case of any corporation the accumulated taxable income of which would (but for this sentence) be determined without allowance of any deductions, the deduction under this paragraph shall be allowed and shall be appropriately adjusted to take into account any deductions which reduced such inclusion.

(c) Accumulated earnings credit

(1) General rule—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum credit—

(A) In general—The credit allowable under paragraph (1) shall in no case be less than the amount by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the

preceding taxable year.

(B) Certain service corporations—In the case of a corporation the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, subparagraph (A) shall be applied by substituting "$150,000" for "$250,000".

(3) Holding and investment companies—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated earnings and profits—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563(a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) Cross reference—For limitation on credit provided in paragraph (2) or (3) in the case of certain controlled corporations, see section 1561.

§541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 20 percent of the undistributed personal holding company income.

§542. DEFINITION OF PERSONAL HOLDING COMPANY

(a) General rule

For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) Adjusted ordinary gross income requirement—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) Stock ownership requirement—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 401(a), 501(c)(17), or 509(a) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c) or a corresponding provision of a prior income tax law shall be considered an individual.

(b) Corporations filing consolidated returns

(1) General rule—In the case of an affiliated group of corporations filing or required to file a consolidated return under section 1501 for any taxable year, the adjusted ordinary gross income requirement of subsection (a)(1) of this section shall, except as provided in paragraphs (2) and (3), be applied for such year with respect to the consolidated adjusted ordinary gross income and the consolidated personal holding company income of the affiliated group. No member of such an affiliated group shall be considered to meet such adjusted ordinary gross income requirement unless the affiliated group meets such requirement.

(2) Ineligible affiliated group—Paragraph (1) shall not apply to an affiliated group of corporations if—

(A) any member of the affiliated group of corporations (including the common parent corporation) derived 10 percent or more of its adjusted ordinary gross income for the taxable year from sources outside the affiliated group, and

(B) 80 percent or more of the amount described in subparagraph (A) consists of personal holding company income (as defined in section 543).

For purposes of this paragraph, section 543 shall be applied as if the amount described in subparagraph (A) were the adjusted ordinary gross income of the corporation.

(3) Excluded corporations—Paragraph (1) shall not apply to an affiliated group of corporations if any member of the affiliated group (including the common parent corporation) is a corporation excluded from the definition of personal holding company under subsection (c).

(4) Certain dividend income received by a common parent—In applying paragraph (2) (A) and (B), personal holding company income and adjusted ordinary gross income shall not include dividends received by a common parent corporation from another corporation if—

(A) the common parent corporation owns, directly or indirectly, more than 50 percent of the outstanding voting stock of such other corporation, and

(B) such other corporation is not a personal holding company for the taxable year in which the dividends are paid.

(5) Certain dividend income received from a nonincludible life insurance company—In the case of an affiliated group of corporations filing or required to file a consolidated return under section 1501 for any taxable year, there shall be excluded from consolidated personal holding company income and consolidated adjusted ordinary gross income for purposes of this part dividends received by a member of the affiliated group from a life insurance company taxable under section 801 that is not a member of the affiliated group solely by reason of the application of paragraph (2) of subsection (b) of section 1504.

§543. PERSONAL HOLDING COMPANY INCOME

(a) General rule

For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:

(1) Dividends, etc.—Dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties), and annuities. This paragraph shall not apply to—

(A) interest constituting rent (as defined in subsection (b)(3)),

(B) interest on amounts set aside in a reserve fund under chapter 533 or 535 of title 46, United States Code,

(C) dividends received by a United States shareholder (as defined in section 951(b)) from a controlled foreign corporation (as defined in section 957(a)),

(D) active business computer software royalties (within the meaning of subsection (d)), and

(E) interest received by a broker or dealer (within the meaning of section 3(a)(4) or (5) of the Securities and Exchange Act of 1934) in connection with—

(i) any securities or money market instruments held as property described in section 1221(a)(1),

(ii) margin accounts, or

(iii) any financing for a customer secured by securities or money market instruments.

(2) Rents—The adjusted income from rents; except that such adjusted income shall not be included if—

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

(B) the sum of—

(i) the dividends paid during the taxable year (determined under section 562),

(ii) the dividends considered as paid on the last day of the taxable year under section 563(c) (as limited by the second sentence of section 563(b)), and

(iii) the consent dividends for the taxable year (determined under section 565),

equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10 percent of the ordinary gross income.

(3) Mineral, oil, and gas royalties—The adjusted income from mineral, oil, and gas royalties; except that such adjusted income shall not be included if—

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income,

(B) the personal holding company income for the taxable year (computed without regard to this paragraph, and computed by including as personal holding company income copyright royalties and the adjusted income from rents) is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than—

(i) deductions for compensation for personal services rendered by the shareholders, and

(ii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 15 percent of the adjusted ordinary gross income.

(4) Copyright royalties—Copyright royalties; except that copyright royalties shall not be included if—

(A) such royalties (exclusive of royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole, or in part, by any shareholder) constitute 50 percent or more of the ordinary gross income,

(B) the personal holding company income for the taxable year computed—

(i) without regard to copyright royalties, other than royalties received for the use of, or right to use, copyrights or interests in copyrights in works created in whole, or in part, by any shareholder owning more than 10 percent of the total outstanding capital stock of the corporation,

(ii) without regard to dividends from any corporation in which the taxpayer owns at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock and which corporation meets the requirements of this subparagraph and subparagraphs (A) and (C), and

(iii) by including as personal holding company income the adjusted income from rents and the adjusted income from mineral, oil, and gas royalties,

is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are properly allocable to such royalties and which are allowable under section 162, other than—

(i) deductions for compensation for personal services rendered by the shareholders,

(ii) deductions for royalties paid or accrued, and

(iii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 25 percent of the amount by which the ordinary gross income exceeds the sum of the royalties paid or accrued and the amounts allowable as deductions under section 167 (relating to depreciation) with respect to copyright royalties.

For purposes of this subsection, the term "copyright royalties" means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code and to which copyright protection is also extended by the laws of any country other than the United States of America by virtue of any international treaty, convention, or agreement, or interests in any such copyrighted works, and includes payments from any person for performing rights in any such copyrighted work and payments (other than produced film rents as defined in paragraph (5)(B)) received for the use of, or right to use, films. For purposes of this paragraph, the term "shareholder" shall include any person who owns stock within the meaning of section 544. This paragraph shall not apply to active business computer software royalties.

(5) Produced film rents—

(A) Produced film rents; except that such rents shall not be included if such rents constitute 50 percent or more of the ordinary gross income.

(B) For purposes of this section, the term "produced film rents" means payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. In the case of a producer who actively participates in the production of the film, such term includes an interest in the proceeds or profits from the film, but only to the extent such interest is attributable to such active participation.

(6) Use of corporate property by shareholder—

(A) Amounts received as compensation (however designated and from whomever received) for the use of, or the right to use, tangible property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property (whether such right is obtained directly

from the corporation or by means of a sublease or other arrangement).

(B) Subparagraph (A) shall apply only to a corporation which has personal holding company income in excess of 10 percent of its ordinary gross income.

(C) For purposes of the limitation in subparagraph (B), personal holding company income shall be computed—

(i) without regard to subparagraph (A) or paragraph (2),

(ii) by excluding amounts received as compensation for the use of (or right to use) intangible property (other than mineral, oil, or gas royalties or copyright royalties) if a substantial part of the tangible property used in connection with such intangible property is owned by the corporation and all such tangible and intangible property is used in the active conduct of a trade or business by an individual or individuals described in subparagraph (A), and

(iii) by including copyright royalties and adjusted income from mineral, oil, and gas royalties.

(7) Personal service contracts—

(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(8) Estates and trusts—Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries).

§545. UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME

(a) Definition

For purposes of this part, the term “undistributed personal holding company income” means the taxable income of a personal holding company adjusted in the manner provided in subsections (b), (c), and (d), minus the dividends paid deduction as defined in section 561. In the case of a personal holding company which is a foreign corporation, not more than 10 percent in value of the outstanding stock of which is owned (within the meaning of section 958(a)) during the last half of the taxable year by United States persons, the term “undistributed personal holding company income” means the amount determined by multiplying the undistributed personal holding company income (determined without regard to this sentence) by the percentage in value of its outstanding stock which is the greatest percentage in value of its outstanding stock so owned by United States persons on any one day during such period.

§561. DEFINITION OF DEDUCTION FOR DIVIDENDS PAID

(a) General rule

The deduction for dividends paid shall be the sum of—

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

§1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

(a) Computation of gain or loss
The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss
Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) Installment sales
Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(e) Certain term interests

(1) In general—In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) Term interest in property defined—For purposes of paragraph (1), the term "term interest in property" means—

(A) a life interest in property,

(B) an interest in property for a term of years, or

(C) an income interest in a trust.

(3) Exception—Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

§1012. BASIS OF PROPERTY—COST

(a) In general
The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).

§1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT

(a) In general

Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—

(1) the fair market value of the property at the date of the decedent's death,

(2) in the case of an election under section 2032, its value at the applicable valuation date prescribed by such section,

(3) in the case of an election under section 2032A, its value determined under such section, or

(4) to the extent of the applicability of the exclusion described in section 2031(c), the basis in the hands of the decedent.

§1032. EXCHANGE OF STOCK FOR PROPERTY

(a) Nonrecognition of gain or loss
No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities futures contract (as defined in section 1234B), to buy or sell its stock (including treasury stock).

(b) Basis
For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

§1059. CORPORATE SHAREHOLDER'S BASIS IN STOCK REDUCED BY NONTAXED PORTION OF EXTRAORDINARY DIVIDENDS

(a) General rule

If any corporation receives any extraordinary dividend with respect to any share of stock and such corporation has not held such stock for more than 2 years before the dividend announcement date—

(1) Reduction in basis—The basis of such corporation in such stock shall be reduced (but not below zero) by the nontaxed portion of such dividends.

(2) Amounts in excess of basis—If the nontaxed portion of such dividends exceeds such basis, such excess shall be treated as gain from the sale or exchange of such stock for the taxable year in which the extraordinary dividend is received.

(b) Nontaxed portion

For purposes of this section—

(1) In general—The nontaxed portion of any dividend is the excess (if any) of—

(A) the amount of such dividend, over

(B) the taxable portion of such dividend.

(2) Taxable portion—The taxable portion of any dividend is—

(A) the portion of such dividend includible in gross income, reduced by

(B) the amount of any deduction allowable with respect to such dividend under section 2431 245, or 245A.

(c) Extraordinary dividend defined

For purposes of this section—

(1) In general—The term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds the threshold percentage of the taxpayer's adjusted basis in such share of stock.

(2) Threshold percentage—The term "threshold percentage" means—

(A) 5 percent in the case of stock which is preferred as to dividends, and

(B) 10 percent in the case of any other stock.

(3) Aggregation of dividends—

(A) Aggregation within 85-day period—All dividends—

(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and

(ii) which have ex-dividend dates within the same period of 85 consecutive days,

shall be treated as 1 dividend.

(B) Aggregation within 1 year where dividends exceed 20 percent of adjusted basis—All dividends—

(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and

(ii) which have ex-dividend dates during the same period of 365 consecutive days,

shall be treated as extraordinary dividends if the aggregate of such dividends exceeds 20 percent of the taxpayer's adjusted basis in such stock (determined without regard to this section).

(C) Substituted basis transactions—In the case of any stock, a person is described in this subparagraph if—

(i) the basis of such stock in the hands of such person is determined in whole or in part by reference to the basis of such stock in the hands of the taxpayer, or

(ii) the basis of such stock in the hands of the taxpayer is determined in whole or in part by reference to the basis of such stock in the hands of such person.

(4) Fair market value determination—If the taxpayer establishes to the satisfaction of the Secretary the fair market value of any share of stock as of the day before the ex-dividend date, the taxpayer may elect to apply paragraphs (1) and (3) by substituting such value for the taxpayer's adjusted basis.

(d) Special rules

For purposes of this section—

(1) Time for reduction—Any reduction in basis under subsection (a)(1) shall be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

(2) Distributions in kind—To the extent any dividend consists of property other than cash, the amount of such dividend shall be treated as the fair market value of such property (as of the date of the distribution) reduced as provided in section 301(b)(2).

(3) Determination of holding period—For purposes of determining the holding period of stock under subsection (a), rules similar to the rules of paragraphs (3) and (4) of section 246(c) shall apply and there shall not be taken into account any day which is more than 2 years after the date on which such share becomes ex-dividend.

(4) Ex-dividend date—The term "ex-dividend date" means the date on which the share of stock becomes ex-dividend.

(5) Dividend announcement date—The term "dividend announcement date" means, with respect to any dividend, the date on which the corporation declares, announces, or agrees to the amount or payment of such dividend, whichever is the earliest.

(6) Exception where stock held during entire existence of corporation—

(A) In general—Subsection (a) shall not apply to any extraordinary dividend with respect to any share of stock of a corporation if—

(i) such stock was held by the taxpayer during the entire period such corporation was in existence, and

(ii) except as provided in regulations, no earnings and profits of such corporation were attributable to transfers of property from (or earnings and profits of) a corporation which is not a qualified corporation.

(B) Qualified corporation—For purposes of subparagraph (A), the term "qualified corporation" means any corporation (including a predecessor corporation)—

(i) with respect to which the taxpayer holds directly or indirectly during the entire period of such corporation's existence at least the same ownership interest as the taxpayer holds in the corporation distributing the extraordinary dividend, and

(ii) which has no earnings and profits—

(I) which were earned by, or

(II) which are attributable to gain on property which accrued during a period the corporation holding the property was,

a corporation not described in clause (i).

(C) Application of paragraph—This paragraph shall not apply to any extraordinary dividend to the extent such application is inconsistent with the purposes of this section.

(e) Special rules for certain distributions

(1) Treatment of partial liquidations and certain redemptions—Except as otherwise provided in regulations—

(A) Redemptions—In the case of any redemption of stock—

(i) which is part of a partial liquidation (within the meaning of section 302(e)) of the redeeming corporation,

(ii) which is not pro rata as to all shareholders, or

(iii) which would not have been treated (in whole or in part) as a dividend if—

(I) any options had not been taken into account under section 318(a)(4), or

(II) section 304(a) had not applied,

any amount treated as a dividend with respect to such redemption shall be treated as an extraordinary dividend to which paragraphs (1) and (2) of subsection (a) apply without regard to the period the taxpayer held such stock. In the case of a redemption described in clause (iii), only the basis in the stock redeemed shall be taken into account under subsection (a).

(B) Reorganizations, etc.—An exchange described in section 356 which is treated as a dividend shall be treated as a redemption of stock for purposes of applying subparagraph (A).

(2) Qualifying dividends—

(A) In general—Except as provided in regulations, the term "extraordinary dividend" does not include any qualifying dividend (within the meaning of section 243).

(B) Exception—Subparagraph (A) shall not apply to any portion of a dividend which is attributable to earnings and profits which—

(i) were earned by a corporation during a period it was not a member of the affiliated group, or

(ii) are attributable to gain on property which accrued during a period the corporation holding the property was not a member of the affiliated group.

(3) Qualified preferred dividends—

(A) In general—In the case of 1 or more qualified preferred dividends with respect to any share of stock—

(i) this section shall not apply to such dividends if the taxpayer holds such stock for more than 5 years, and

(ii) if the taxpayer disposes of such stock before it has been held for more than 5 years, the aggregate reduction under subsection (a)(1) with respect to such dividends shall not be greater than the excess (if any) of—

(I) the qualified preferred dividends paid with respect to such stock during the period the taxpayer held such stock, over

(II) the qualified preferred dividends which would have been paid during such period on the basis of the stated rate of return.

(B) Rate of return—For purposes of this paragraph—

(i) Actual rate of return—The actual rate of return shall be the rate of return for the period for which the taxpayer held the stock, determined—

(I) by only taking into account dividends during such period, and

(II) by using the lesser of the adjusted basis of the taxpayer in such stock or the liquidation preference of such stock.

(ii) Stated rate of return—The stated rate of return shall be the annual rate of the qualified preferred dividend payable with respect to any share of stock (expressed as a percentage of the amount described in clause (i)(II)).

(C) Definitions and special rules—For purposes of this paragraph—

(i) Qualified preferred dividend—The term "qualified preferred dividend" means any fixed dividend payable with respect to any share of stock which—

(I) provides for fixed preferred dividends payable not less frequently than annually, and

(II) is not in arrears as to dividends at the time the taxpayer acquires the stock.

Such term shall not include any dividend payable with respect to any share of stock if the actual rate of return on such stock exceeds 15 percent.

(ii) Holding period—In determining the holding period for purposes of subparagraph (A)(ii), subsection (d)(3) shall be applied by substituting "5 years" for "2 years".

§1060. SPECIAL ALLOCATION RULES FOR CERTAIN ASSET ACQUISITIONS

(a) General rule

In the case of any applicable asset acquisition, for purposes of determining both—

(1) the transferee's basis in such assets, and

(2) the gain or loss of the transferor with respect to such acquisition,

the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.

(b) Information required to be furnished to Secretary

Under regulations, the transferor and transferee in an applicable asset acquisition shall, at such times and in such manner as may be provided in such regulations, furnish to the Secretary the following information:

(1) The amount of the consideration received for the assets which is allocated to section 197 intangibles.

(2) Any modification of the amount described in paragraph (1).

(3) Any other information with respect to other assets transferred in such acquisition as the Secretary deems necessary to carry out the provisions of this section.

(c) Applicable asset acquisition

For purposes of this section, the term "applicable asset acquisition" means any transfer (whether directly or indirectly)—

(1) of assets which constitute a trade or business, and

(2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets.

A transfer shall not be treated as failing to be an applicable asset acquisition merely because section 1031 applies to a portion of the assets transferred.

§1202. PARTIAL EXCLUSION FOR GAIN FROM CERTAIN SMALL BUSINESS STOCK

(a) Exclusion

(1) In general—In the case of a taxpayer other than a corporation, gross income shall not include—

(A) except as provided in paragraphs (3) and (4), 50 percent of any gain from the sale or exchange of qualified small business stock acquired on or before the applicable date and held for more than 5 years, and

(B) the applicable percentage of any gain from the sale or exchange of qualified small business stock acquired after the applicable date and held for at least 3 years.

(2) Empowerment zone businesses—

(A) In general—In the case of qualified small business stock acquired after the date of the enactment of this paragraph in a corporation which is a qualified business entity (as defined in section 1397C(b)) during substantially all of the taxpayer's holding period for such stock, paragraph (1) shall be applied by substituting "60 percent" for "50 percent".

(B) Certain rules to apply—Rules similar to the rules of paragraphs (5) and (7) of section 1400B(b) (as in effect before its repeal) shall apply for purposes of this paragraph.

(C) Gain after 2018 not qualified—Subparagraph (A) shall not apply to gain attributable to periods after December 31, 2018.

(D) Treatment of DC zone—The District of Columbia Enterprise Zone shall not be treated as an empowerment zone for purposes of this paragraph.

(3) Special rules for 2009 and certain periods in 2010—In the case of qualified small business stock acquired after the date of the enactment of this paragraph and on or before the date of the enactment of the Creating Small Business Jobs Act of 2010—

(A) paragraph (1)(A) shall be applied by substituting "75 percent" for "50 percent", and

(B) paragraph (2) shall not apply.

In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223.

(4) 100 percent exclusion for stock acquired during certain periods in 2010 and thereafter—In the case of qualified small business stock acquired after the date of the enactment of the Creating Small Business Jobs Act of 2010 and on or before the applicable date—

(A) paragraph (1)(A) shall be applied by substituting "100 percent" for "50 percent",1

(B) paragraph (2) shall not apply.

In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223.

(5) Applicable percentage—The applicable percentage under paragraph (1) shall be determined under the following table:

Years stock held:	**Applicablepercentage:**
3 years	50%
4 years	75%
5 years or more	100%

(6) Applicable date; acquisition date—For purposes of this section—

(A) Applicable date—The term "applicable date" means the date of the enactment of this paragraph.

(B) Acquisition date—In the case of any stock which would (but for this paragraph) be treated as having been acquired before, on, or after the applicable date, whichever is applicable, the acquisition date for purposes of this section shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223.

(b) Per-issuer limitation on taxpayer's eligible gain

(1) In general—If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account under subsection (a) for the taxable year shall not exceed the greater of—

(A) the applicable dollar limit for the taxable year, or

(B) 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.

For purposes of subparagraph (B), the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.

(2) Eligible gain—For purposes of this subsection, the term "eligible gain" means any gain from the sale or exchange of qualified small business stock held for at least 3 years (more than 5 years in the case of stock acquired on or before the applicable date).

(3) Treatment of married individuals—

(A) Separate returns—In the case of a separate return by a married individual for any taxable year—

(i) paragraph (4)(A) shall be applied by substituting "$5,000,000" for "$10,000,000", and

(ii) paragraph (4)(B) shall be applied by substituting one-half of the dollar amount in effect under such paragraph for the taxable year for the amount so in effect.

(B) Allocation of exclusion—In the case of any joint return, the amount of gain taken into account under subsection (a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.

(C) Marital status—For purposes of this subsection, marital status shall be determined under section 7703.

(4)2 Applicable dollar limit—For purposes of paragraph (1)(A), the applicable dollar limit for any taxable year with respect to eligible gain from 1 or more dispositions by a taxpayer of qualified business stock of a corporation is—

(A) if such stock was acquired by the taxpayer on or before the applicable date, $10,000,000, reduced by the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for prior taxable years and attributable to dispositions of stock issued by such corporation and acquired by the taxpayer before, on, or after the applicable date, and

(B) if such stock was acquired by the taxpayer after the applicable date, $15,000,000, reduced by the sum of—

(i) the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for prior taxable years and attributable to dispositions of stock issued by such corporation and acquired by the taxpayer before, on, or after the applicable date, plus

(ii) the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for the taxable year and attributable to dispositions of stock issued by such corporation and acquired by the taxpayer on or before the applicable date.

(5) Inflation adjustment—

(A) In general—In the case of any taxable year beginning after 2026, the $15,000,000 amount in paragraph (4)(B) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2025" for "calendar year 2016" in subparagraph (A)(ii) thereof.

If any increase under this subparagraph is not a multiple of $10,000, such increase shall be rounded to the nearest multiple of $10,000.

(B) No increase once limit reached—If, for any taxable year, the eligible gain attributable to dispositions of stock issued by a corporation and acquired by the taxpayer after the applicable date exceeds the applicable dollar limit, then notwithstanding any increase under subparagraph (A) for any subsequent taxable year, the applicable dollar limit for such subsequent taxable year shall be zero.

(4)[2] Inflation adjustment—In the case of any taxable year beginning after 2026, the $75,000,000 amounts in paragraphs (1)(A) and (1)(B) shall each be increased by an amount equal to—

(A) such dollar amount, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2025" for "calendar year 2016" in subparagraph (A)(ii) thereof.

If any increase under this paragraph is not a multiple of $10,000, such increase shall be rounded to the nearest multiple of $10,000.

(c) Qualified small business stock

For purposes of this section—

(1) In general—Except as otherwise provided in this section, the term "qualified small business stock" means any stock in a C corporation which is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if—

(A) as of the date of issuance, such corporation is a qualified small business, and

(B) except as provided in subsections (f) and (h), such stock is acquired by the taxpayer at its original issue (directly or through an underwriter)—

(i) in exchange for money or other property (not including stock), or

(ii) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).

(2) Active business requirement; etc.—

(A) In general—Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation.

(B) Special rule for certain small business investment companies—

(i) Waiver of active business requirement—Notwithstanding any provision of subsection (e), a corporation shall be treated as meeting the active business requirements of such subsection for any period during which such corporation qualifies as a specialized small business investment company.

(ii) Specialized small business investment company—For purposes of clause (i), the term "specialized small business investment company" means any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

(3) Certain purchases by corporation of its own stock—

(A) Redemptions from taxpayer or related person—Stock acquired by the taxpayer shall not be treated as qualified small business stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(B) Significant redemptions—Stock issued by a corporation shall not be treated as qualified business stock if, during the 2-year period beginning on the date 1 year before the issuance of such stock, such corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of such 2-year period.

(C) Treatment of certain transactions—If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of subparagraphs (A) and (B), such corporation shall be treated as purchasing an amount of its stock equal to the amount treated as such a distribution under section 304(a).

(d) Qualified small business

For purposes of this section—

(1) In general—The term "qualified small business" means any domestic corporation which is a C corporation if—

(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance did not exceed $75,000,000,

(B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $75,000,000, and

(C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section.

(2) Aggregate gross assets—

(A) In general—For purposes of paragraph (1), the term "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation.

(B) Treatment of contributed property—For purposes of subparagraph (A), the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.

(3) Aggregation rules—

(A) In general—All corporations which are members of the same parent-subsidiary controlled group shall be treated as 1 corporation for purposes of this subsection.

(B) Parent-subsidiary controlled group—For purposes of subparagraph (A), the term "parent-subsidiary controlled group" means any controlled group of corporations as defined in section 1563(a)(1), except that—

(i) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and

(ii) section 1563(a)(4) shall not apply.

(e) Active business requirement

(1) In general—For purposes of subsection (c)(2), the requirements of this subsection are met by a corporation for any period if during such period—

(A) at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses, and

(B) such corporation is an eligible corporation.

(2) Special rule for certain activities—For purposes of paragraph (1), if, in connection with any future qualified trade or business, a corporation is engaged in—

(A) start-up activities described in section 195(c)(1)(A),

(B) activities resulting in the payment or incurring of expenditures which are treated as foreign research or experimental expenditures under section 174 or domestic research or experimental expenditures under section 174A, or

(C) activities with respect to in-house research expenses described in section 41(b)(4),

assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

(3) Qualified trade or business—For purposes of this subsection, the term "qualified trade or business" means any trade or business other than—

(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,

(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

(4) Eligible corporation—For purposes of this subsection, the term "eligible corporation" means any domestic corporation; except that such term shall not include—

(A) a DISC or former DISC,

(B) a regulated investment company, real estate investment trust, or REMIC, and

(C) a cooperative.

(5) Stock in other corporations—

(A) Look-thru in case of subsidiaries—For purposes of this subsection, stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities.

(B) Portfolio stock or securities—A corporation shall be treated as failing to meet the requirements of paragraph (1) for any period during which more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described in paragraph (6)).

(C) Subsidiary—For purposes of this paragraph, a corporation shall be considered a subsidiary if the parent owns more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation.

(6) Working capital—For purposes of paragraph (1)(A), any assets which—

(A) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or

(B) are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business,

shall be treated as used in the active conduct of a qualified trade or business. For periods after the corporation has been in existence for at least 2 years, in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of this paragraph.

(7) Maximum real estate holdings—A corporation shall not be treated as meeting the requirements of paragraph (1) for any period during which more than 10 percent of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business. For purposes of the preceding sentence, the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.

(8) Computer software royalties—For purposes of paragraph (1), rights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1)) shall be treated as an asset used in the active conduct of a trade or business.

(f) Stock acquired on conversion of other stock

If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer—

(1) the stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer, and

(2) the stock so acquired shall be treated as having been held during the period during which the converted stock was held.

(h) Certain tax-free and other transfers

For purposes of this section—

(1) In general—In the case of a transfer described in paragraph (2), the transferee shall be treated as—

(A) having acquired such stock in the same manner as the transferor, and

(B) having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under this subsection) by the transferor.

(2) Description of transfers—A transfer is described in this subsection if such transfer is—

(A) by gift,

(B) at death, or

(C) from a partnership to a partner of stock with respect to which requirements similar to the requirements of subsection (g) are met at the time of the transfer (without regard to the 5-year holding period requirement).

(3) Certain rules made applicable—Rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section.

(4) Incorporations and reorganizations involving nonqualified stock—

(A) In general—In the case of a transaction described in section 351 or a reorganization described in section 368, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this subparagraph, such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.

(B) Limitation—This section shall apply to gain from the sale or exchange of stock treated as qualified small business stock by reason of subparagraph (A) only to the extent of the gain which would have been recognized at the time of the transfer described in subparagraph (A) if section 351 or 368 had not applied at such time. The preceding sentence shall not apply if the stock which is treated as qualified small business stock by reason of subparagraph (A) is issued by a corporation which (as of the time of the transfer described in subparagraph (A)) is a qualified small business.

(C) Successive application—For purposes of this paragraph, stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which such limitation applied (determined after the application of the second sentence of subparagraph (B)).

(D) Control test—In the case of a transaction described in section 351, this paragraph shall apply only if, immediately after the transaction, the corporation issuing the stock owns directly or indirectly stock representing control (within the meaning of section 368(c)) of the corporation whose stock was exchanged.

(i) Basis rules

For purposes of this section—

(1) Stock exchanged for property—In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—

(A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and

(B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

(2) Treatment of contributions to capital—If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

§1211. LIMITATION ON CAPITAL LOSSES

(a) Corporations
In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

§1212. CAPITAL LOSS CARRYBACKS AND CARRYOVERS

(a) Corporations

(1) In general—If a corporation has a net capital loss for any taxable year (hereinafter in this paragraph referred to as the "loss year"), the amount thereof shall be—

(A) a capital loss carryback to each of the 3 taxable years preceding the loss year, but only to the extent—

(i) such loss is not attributable to a foreign expropriation capital loss, and

(ii) the carryback of such loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is being carried back;

(B) except as provided in subparagraph (C), a capital loss carryover to each of the 5 taxable years succeeding the loss year; and

(C) a capital loss carryover to each of the 10 taxable years succeeding the loss year, but only to the extent such loss is attributable to a foreign expropriation loss,

and shall be treated as a short-term capital loss in each such taxable year. The entire amount of the net capital loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried, and the portion of such loss which shall be carried to each of the other taxable years to which such loss may be carried shall be the excess, if any, of such loss over the total of the capital gain net income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the capital gain net income for any such prior taxable year shall be computed without regard to the net capital loss for the loss year or for any taxable year thereafter. In the case of any net capital loss which cannot be carried back in full to a preceding taxable year by reason of clause (ii) of subparagraph (A), the capital gain net income for such prior taxable year shall in no case be treated as greater than the amount of such loss which can be carried back to such preceding taxable year upon the application of such clause (ii).

(2) Definitions and special rules—

(A) Foreign expropriation capital loss defined—For purposes of this subsection, the term "foreign expropriation capital loss" means, for any taxable year, the sum of the losses taken into account in computing the net capital loss for such year which are—

(i) losses sustained directly by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, or

(ii) losses (treated under section 165(g)(1) as losses from the sale or exchange of capital assets) from securities which become worthless by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing.

(B) Portion of loss attributable to foreign expropriation capital loss—For purposes of paragraph (1), the portion of any net capital loss for any taxable year attributable to a foreign expropriation capital loss is the amount of the foreign expropriation capital loss for such year (but not in excess of the net capital loss for such year).

(C) Priority of application—For purposes of paragraph (1), if a portion of a net capital loss for any taxable year is attributable to a foreign expropriation capital loss, such portion shall be considered to be a separate net capital loss for such year to be applied after the other portion of such net capital loss.

(3) Regulated investment companies—

(A) In general—If a regulated investment company has a net capital loss for any taxable year—

(i) paragraph (1) shall not apply to such loss,

(ii) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss arising on the first day of the next taxable year, and

(iii) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss arising on the first day of the next taxable year.

(B) Coordination with general rule—If a net capital loss to which paragraph (1) applies is carried over to a taxable year of a regulated investment company—

(i) Losses to which this paragraph applies—Clauses (ii) and (iii) of subparagraph (A) shall be applied without regard to any amount treated as a short-term capital loss under paragraph (1).

(ii) Losses to which general rule applies—Paragraph (1) shall be applied by substituting "net capital loss for the loss year or any taxable year thereafter (other than a net capital loss to which paragraph (3)(A) applies)" for "net capital loss for the loss year or any taxable year thereafter".

(4) Special rules on carrybacks—A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

(A) for which it is a regulated investment company (as defined in section 851), or

(B) for which it is a real estate investment trust (as defined in section 856).

§1221. CAPITAL ASSET DEFINED

(a) In general

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);

(6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless—

(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

(B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);

(7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

(b) Definitions and special rules

(1) Commodities derivative financial instruments—For purposes of subsection (a)(6)—

(A) Commodities derivatives dealer—The term "commodities derivatives dealer" means a person which1 regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.

(B) Commodities derivative financial instrument—

(i) In general—The term "commodities derivative financial instrument" means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b))), the value or settlement price of which is calculated by or determined by reference to a specified index.

(ii) Specified index—The term "specified index" means any one or more or any combination of—

(I) a fixed rate, price, or amount, or

(II) a variable rate, price, or amount,

which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances.

(2) Hedging transaction—

(A) In general—For purposes of this section, the term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—

(i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,

(ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or

(iii) to manage such other risks as the Secretary may prescribe in regulations.

(B) Treatment of nonidentification or improper identification of hedging transactions—Notwithstanding subsection (a)(7), the Secretary shall prescribe regulations to properly characterize any income, gain, expense, or loss arising from a transaction—

(i) which is a hedging transaction but which was not identified as such in accordance with subsection (a)(7), or

(ii) which was so identified but is not a hedging transaction.

(3) Sale or exchange of self-created musical works—At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3).

(4) Regulations—The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (6) and (7) of subsection (a) in the case of transactions involving related parties.

§1223. HOLDING PERIOD OF PROPERTY

For purposes of this subtitle—

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph—

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 1091 relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(4) In determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under section 307, there shall (under regulations prescribed by the Secretary) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution.

(5) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised.

[(6) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(80)(C), Dec. 19, 2014, 128 Stat. 4049.]

(7) In determining the period for which the taxpayer has held a commodity acquired in satisfaction of a commodity futures contract (other than a commodity futures contract to which section 1256 applies) there shall be included the period for which he held the commodity futures contract if such commodity futures contract was a capital asset in his hands.

[(8) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(80)(C), Dec. 19, 2014, 128 Stat. 4049.]

(9) In the case of a person acquiring property from a decedent or to whom property passed from a decedent (within the meaning of section 1014(b)), if—

(A) the basis of such property in the hands of such person is determined under section 1014, and

(B) such property is sold or otherwise disposed of by such person within 1 year after the decedent's death,

then such person shall be considered to have held such property for more than 1 year.

(10) If—

(A) property is acquired by any person in a transfer to which section 1040 applies,

(B) such property is sold or otherwise disposed of by such person within 1 year after the decedent's death, and

(C) such sale or disposition is to a person who is a qualified heir (as defined in section 2032A(e)(1)) with respect to the decedent,

then the person making such sale or other disposition shall be considered to have held such property for more than 1 year.

(11) In determining the period for which the taxpayer has held qualified replacement property (within the meaning of section 1042(b)) the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale of qualified securities (within the meaning of section 1042(b)), there shall be included the period for which such qualified securities had been held by the taxpayer.

(12) In determining the period for which the taxpayer has held property the acquisition of which resulted under section 1043 in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property had been held as of the date of such sale.

(13) Except for purposes of subsections (a)(2) and (c)(2)(A) of section 1202, in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045 or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period

for which such other property has been held as of the date of such sale.

(14) If the security to which a securities futures contract (as defined in section 1234B) relates (other than a contract to which section 1256 applies) is acquired in satisfaction of such contract, in determining the period for which the taxpayer has held such security, there shall be included the period for which the taxpayer held such contract if such contract was a capital asset in the hands of the taxpayer.

(15) Cross reference.——For special holding period provision relating to certain partnership distributions, see section 735(b).

§1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS

(b) Definition of property used in the trade or business

For purposes of this section—

(1) General rule—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a), or

(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221(a).

(2) Timber, coal, or domestic iron ore—Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) Livestock—Such term includes—

(A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition.

Such term does not include poultry.

(4) Unharvested crop—In the case of an unharvested crop on land used in the trade or business and held for more than 1 year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

§1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(a) General rule

(1) Ordinary income—Except as otherwise provided in this section, if section 1245 property is disposed of the amount by which the lower of—

(A) the recomputed basis of the property, or

(B)

(i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property,

exceeds the adjusted basis of such property shall be treated as ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) Recomputed basis—For purposes of this section—

(A) In general—The term "recomputed basis" means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization.

(B) Taxpayer may establish amount allowed—For purposes of subparagraph (A), if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

(C) Certain deductions treated as amortization—Any deduction allowable under section 179, 179B, 179C, 179D, 179E, 181, 190, 193, or 194 shall be treated as if it were a deduction allowable for amortization.

(3) Section 1245 property—For purposes of this section, the term "section 1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

(A) personal property,

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179B, 179C, 179D, 179E, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 1941

(D) a single purpose agricultural or horticultural structure (as defined in section 168(i)(13)),

(E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum,

(F) any railroad grading or tunnel bore (as defined in section 168(e)(4)), or

(G) any qualified production property (as defined in section 168(n)(2)).

(b) Exceptions and limitations

(1) Gifts—Subsection (a) shall not apply to a disposition by gift.

(2) Transfers at death—Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

(3) Certain tax-free transactions—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). Except as provided in paragraph (6), this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(4) Like kind exchanges; involuntary conversions, etc.—If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of—

(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

(5) Property distributed by a partnership to a partner—

(A) In general—For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) Adjustments added back—In the case of any property described in subparagraph (A), for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

(ii) the amount of such gain to which section 751(b) applied.

(6) Transfers to tax-exempt organization where property will be used in unrelated business—

(A) In general—The second sentence of paragraph (3) shall not apply to a disposition of section 1245 property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses such property in an unrelated trade or business (as defined in section 513).

(B) Later change in use—If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

(7) Timber property—In determining, under subsection (a)(2), the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.

(8) Disposition of amortizable section 197 intangibles—

(A) In general—If a taxpayer disposes of more than 1 amortizable section 197 intangible (as defined in section 197(c)) in a transaction or a series of related transactions, all such amortizable 197 intangibles shall be treated as 1 section 1245 property for purposes of this section.

(B) Exception—Subparagraph (A) shall not apply to any amortizable section 197 intangible (as so defined) with respect to which the adjusted basis exceeds the fair market value.

§1361. S CORPORATION DEFINED

(a) S corporation defined

(1) In general—For purposes of this title, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

(2) C corporation—For purposes of this title, the term "C corporation" means, with respect to any taxable year, a corporation which is not an S corporation for such year.

(b) Small business corporation

(1) In general—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not—

(A) have more than 100 shareholders,

(B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,

(C) have a nonresident alien as a shareholder, and

(D) have more than 1 class of stock.

(2) Ineligible corporation defined—For purposes of paragraph (1), the term "ineligible corporation" means any corporation which is—

(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585,

(B) an insurance company subject to tax under subchapter L, or

(C) a DISC or former DISC.

(3) Treatment of certain wholly owned subsidiaries—

(A) In general—Except as provided in regulations prescribed by the Secretary, for purposes of this title—

(i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and

(ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

(B) Qualified subchapter S subsidiary—For purposes of this paragraph, the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in paragraph (2)), if—

(i) 100 percent of the stock of such corporation is held by the S corporation, and

(ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

(C) Treatment of terminations of qualified subchapter S subsidiary status—

(i) In general—For purposes of this title, if any corporation which was a qualified subchapter S subsidiary ceases to meet the requirements of subparagraph (B), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock.

(ii) Termination by reason of sale of stock—If the failure to meet the requirements of subparagraph (B) is by reason of the sale of stock of a corporation which is a qualified subchapter S subsidiary, the sale of such stock shall be treated as if—

(I) the sale were a sale of an undivided interest in the assets of such corporation (based on the percentage of the corporation's stock sold), and

(II) the sale were followed by an acquisition by such corporation of all of its assets (and the assumption by such corporation of all of its liabilities) in a transaction to which section 351 applies.

(D) Election after termination—If a corporation's status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make—

(i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or

(ii) an election under section 1362(a) to be treated as an S corporation,

before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

(E) Information returns—Except to the extent provided by the Secretary, this paragraph shall not apply to part III of subchapter A of chapter 61 (relating to information returns).

(c) Special rules for applying subsection (b)

(1) Members of a family treated as 1 shareholder—

(A) In general—For purposes of subsection (b)(1)(A), there shall be treated as one shareholder—

(i) a husband and wife (and their estates), and

(ii) all members of a family (and their estates).

(B) Members of a family—For purposes of this paragraph—

(i) In general—The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.

(ii) Common ancestor—An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than 6 generations removed from the youngest generation of shareholders who would (but for this subparagraph) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married.

(iii) Applicable date—The term "applicable date" means the latest of—

(I) the date the election under section 1362(a) is made,

(II) the earliest date that an individual described in clause (i) holds stock in the S corporation, or

(III) October 22, 2004.

(C) Effect of adoption, etc.—Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

(2) Certain trusts permitted as shareholders—

(A) In general—For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death.

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it.

(iv) A trust created primarily to exercise the voting power of stock transferred to it.

(v) An electing small business trust.

(vi) In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank or company as of the date of the enactment of this clause.

This subparagraph shall not apply to any foreign trust.

(B) Treatment as shareholders—For purposes of subsection (b)(1)—

(i) In the case of a trust described in clause (i) of subparagraph (A), the deemed owner shall be treated as the shareholder.

(ii) In the case of a trust described in clause (ii) of subparagraph (A), the estate of the deemed owner shall be treated as the shareholder.

(iii) In the case of a trust described in clause (iii) of subparagraph (A), the estate of the testator shall be treated as the shareholder.

(iv) In the case of a trust described in clause (iv) of subparagraph (A), each beneficiary of the trust shall be treated as a shareholder.

(v) In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period. This clause shall not apply for purposes of subsection (b)(1)(C).

(vi) In the case of a trust described in clause (vi) of subparagraph (A), the individual for whose benefit the trust was created shall be treated as the shareholder.

(3) Estate of individual in bankruptcy may be shareholder—For purposes of subsection (b)(1)(B), the term "estate" includes the estate of an individual in a case under title 11 of the United States Code.

(4) Differences in common stock voting rights disregarded—For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.

(5) Straight debt safe harbor—

(A) In general—For purposes of subsection (b)(1)(D), straight debt shall not be treated as a second class of stock.

(B) Straight debt defined—For purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if—

(i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors,

(ii) there is no convertibility (directly or indirectly) into stock, and

(iii) the creditor is an individual (other than a nonresident alien), an estate, a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money.

(C) Regulations—The Secretary shall prescribe such regulations as may be necessary or appropriate to provide for the proper treatment of straight debt under this subchapter and for the coordination of such treatment with other provisions of this title.

(6) Certain exempt organizations permitted as shareholders—For purposes of subsection (b)(1)(B), an organization which is—

(A) described in section 401(a) or 501(c)(3), and

(B) exempt from taxation under section 501(a),

may be a shareholder in an S corporation.

§1362. ELECTION; REVOCATION; TERMINATION

(a) Election

(1) In general—Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.

(2) All shareholders must consent to election—An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

(d) Termination

(1) By revocation—

(A) In general—An election under subsection (a) may be terminated by revocation.

(B) More than one-half of shares must consent to revocation—An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.

(C) When effective—Except as provided in subparagraph (D)—

(i) a revocation made during the taxable year and on or before the 15th day of the 3d month thereof shall be effective on the 1st day of such taxable year, and

(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

(D) Revocation may specify prospective date—If the revocation specifies a date for revocation which is on or after the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

(2) By corporation ceasing to be small business corporation—

(A) In general—An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

(B) When effective—Any termination under this paragraph shall be effective on and after the date of cessation.

(3) Where passive investment income exceeds 25 percent of gross receipts for 3 consecutive taxable years and corporation has accumulated earnings and profits—

(A) Termination—

(i) In general—An election under subsection (a) shall be terminated whenever the corporation—

(I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and

(II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

(ii) When effective—Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to in clause (i).

(iii) Years taken into account—A prior taxable year shall not be taken into account under clause (i) unless the corporation was an S corporation for such taxable year.

(B) Gross receipts from the sales of certain assets—For purposes of this paragraph—

(i) in the case of dispositions of capital assets (other than stock and securities), gross receipts from such dispositions shall be taken into account only to the extent of the capital gain net income therefrom, and

(ii) in the case of sales or exchanges of stock or securities, gross receipts shall be taken into account only to the extent of the gains therefrom.

(C) Passive investment income defined—

(i) In general—Except as otherwise provided in this subparagraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, and annuities.

(ii) Exception for interest on notes from sales of inventory—The term "passive investment income" shall not include interest on any obligation acquired in the ordinary course of the corporation's trade or business from its sale of property described in section 1221(a)(1).

(iii) Treatment of certain lending or finance companies—If the S corporation meets the requirements of section 542(c)(6) for the taxable year, the term "passive investment income" shall not include gross receipts for the taxable year which are derived directly from the active and regular conduct of a lending or finance business (as defined in section 542(d)(1)).

(iv) Treatment of certain dividends—If an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term "passive investment income" shall not include dividends from such C corporation to the extent such dividends are attributable to the earnings and profits of such C corporation derived from the active conduct of a trade or business.

(v) Exception for banks, etc.—In the case of a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1))), the term "passive investment income" shall not include—

(I) interest income earned by such bank or company, or

(II) dividends on assets required to be held by such bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.

§1363. EFFECT OF ELECTION ON CORPORATION

(a) General rule
Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter.

(b) Computation of corporation's taxable income

The taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that—

(1) the items described in section 1366(a)(1)(A) shall be separately stated,

(2) the deductions referred to in section 703(a)(2) shall not be allowed to the corporation,

(3) section 248 shall apply, and

(4) section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years.

(c) Elections of the S corporation

(1) In general—Except as provided in paragraph (2), any election affecting the computation of items derived from an S corporation shall be made by the corporation.

(2) Exceptions—In the case of an S corporation, elections under the following provisions shall be made by each shareholder separately—

(A) section 617 (relating to deduction and recapture of certain mining exploration expenditures), and

(B) section 901 (relating to taxes of foreign countries and possessions of the United States).

§1366. PASS-THRU OF ITEMS TO SHAREHOLDERS

(a) Determination of shareholder's tax liability

(1) In general—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's—

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined—For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru

The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder

In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions

(1) Cannot exceed shareholder's basis in stock and debt—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions—

(A) In general—Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(B) Transfers of stock between spouses or incident to divorce—In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

(3) Carryover of disallowed losses and deductions to post-termination transition period—

(A) In general—If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder's basis in stock—The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock—The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations—To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(4) Application of limitation on charitable contributions—In the case of any charitable contribution of property to which the second sentence of section 1367(a)(2) applies, paragraph (1) shall not apply to the extent of the excess (if any) of—

(A) the shareholder's pro rata share of such contribution, over

(B) the shareholder's pro rata share of the adjusted basis of such property.

§1367. ADJUSTMENTS TO BASIS OF STOCK OF SHAREHOLDERS, ETC.

(a) General rule

(1) Increases in basis—The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis—The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property.

(b) Special rules

(1) Income items—An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the

extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness—

(A) Reduction of basis—If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis—If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d) This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock—

(A) In general—If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis—The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

§1368. DISTRIBUTIONS

(b) S corporation having no earnings and profits

In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits—

(1) Amount applied against basis—The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

(2) Amount in excess of basis—If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

(c) S corporation having earnings and profits

In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits—

(1) Accumulated adjustments account—That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

(2) Dividend—That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

(3) Treatment of remainder—Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes.

(d) Certain adjustments taken into account

Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—

(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year.

(e) Definitions and special rules

For purposes of this section—

(1) Accumulated adjustments account—

(A) In general—Except as otherwise provided in this paragraph, the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in section 1367(a)(2)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

(B) Amount of adjustment in the case of redemptions—In the case of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

(C) Net loss for year disregarded—

(i) In general—In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.

(ii) Net negative adjustment—For purposes of clause (i), the term "net negative adjustment" means, with respect to any taxable year, the excess (if any) of—

(I) the reductions in the account for the taxable year (other than for distributions), over

(II) the increases in such account for such taxable year.

(2) S period—The term "S period" means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

(3) Election to distribute earnings first—

(A) In general—An S corporation may, with the consent of all of its affected shareholders, elect to have paragraph (1) of subsection (c) not apply to all distributions made during the taxable year for which the election is made.

(B) Affected shareholder—For purposes of subparagraph (A), the term "affected shareholder" means any shareholder to whom a distribution is made by the S corporation during the taxable year.

§1411. IMPOSITION OF TAX

(a) In general

Except as provided in subsection (e)—

(1) Application to individuals—In the case of an individual, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax equal to 3.8 percent of the lesser of—

(A) net investment income for such taxable year, or

(B) the excess (if any) of—

(i) the modified adjusted gross income for such taxable year, over

(ii) the threshold amount.

(2) Application to estates and trusts—In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of—

(A) the undistributed net investment income for such taxable year, or

(B) the excess (if any) of—

(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

(b) Threshold amount

For purposes of this chapter, the term "threshold amount" means—

(1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000,

(2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, ½ of the dollar amount determined under paragraph (1), and

(3) in any other case, $200,000.

(c) Net investment income

For purposes of this chapter—

(1) In general—The term "net investment income" means the excess (if any) of—

(A) the sum of—

(i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),

(ii) other gross income derived from a trade or business described in paragraph (2), and

(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2), over

(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

(2) Trades and businesses to which tax applies—A trade or business is described in this paragraph if such trade or business is—

(A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or

(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

(3) Income on investment of working capital subject to tax—A rule similar to the rule of section 469(e)(1)(B) shall apply for purposes of this subsection.

(4) Exception for certain active interests in partnerships and S corporations—In the case of a disposition of an interest in a partnership or S corporation—

(A) gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest, and

(B) a rule similar to the rule of subparagraph (A) shall apply to a loss from such disposition.

(5) Exception for distributions from qualified plans—The term "net investment income" shall not include any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b).

(6) Special rule—Net investment income shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b).

(d) Modified adjusted gross income

For purposes of this chapter, the term "modified adjusted gross income" means adjusted gross income increased by the excess of—

(1) the amount excluded from gross income under section 911(a)(1), over

(2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).

(e) Nonapplication of section

This section shall not apply to—

(1) a nonresident alien, or

(2) a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).

§1504. DEFINITIONS

(a) Affiliated group defined

For purposes of this subtitle—

(1) In general—The term "affiliated group" means—

(A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if—

(B)

(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

(2) 80-percent voting and value test—The ownership of stock of any corporation meets the requirements of this paragraph if it—

(A) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

(3) 5 years must elapse before reconsolidation—

(A) In general—If—

(i) a corporation is included (or required to be included) in a consolidated return filed by an affiliated group, and

(ii) such corporation ceases to be a member of such group,

with respect to periods after such cessation, such corporation (and any successor of such corporation) may not be included in any consolidated return filed by the affiliated group (or by another affiliated group with the same common parent or a successor of such common parent) before the 61st month beginning after its first taxable year in which it ceased to be a member of such affiliated group.

(B) Secretary may waive application of subparagraph (A) The Secretary may waive the application of subparagraph (A) to any corporation for any period subject to such conditions as the Secretary may prescribe.

(4) Stock not to include certain preferred stock—For purposes of this subsection, the term "stock" does not include any stock which—

(A) is not entitled to vote,

(B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent,

(C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and

(D) is not convertible into another class of stock.

(5) Regulations—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including (but not limited to) regulations—

(A) which treat warrants, obligations convertible into stock, and other similar interests as stock, and stock as not stock,

(B) which treat options to acquire or sell stock as having been exercised,

(C) which provide that the requirements of paragraph (2)(B) shall be treated as met if the affiliated group, in reliance on a good faith determination of value, treated such requirements as met,

(D) which disregard an inadvertent ceasing to meet the requirements of paragraph (2)(B) by reason of changes in relative values of different classes of stock,

(E) which provide that transfers of stock within the group shall not be taken into account in determining whether a corporation ceases to be a member of an affiliated group, and

(F) which disregard changes in voting power to the extent such changes are disproportionate to related changes in value.

§4501. REPURCHASE OF CORPORATE STOCK

(a) General rule
There is hereby imposed on each covered corporation a tax equal to 1 percent of the fair market value of any stock of the corporation which is repurchased by such corporation during the taxable year.

(b) Covered corporation
For purposes of this section, the term “covered corporation” means any domestic corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)).

(c) Repurchase

For purposes of this section—

(1) In general—The term “repurchase” means—

(A) a redemption within the meaning of section 317(b) with regard to the stock of a covered corporation, and

(B) any transaction determined by the Secretary to be economically similar to a transaction described in subparagraph (A).

(2) Treatment of purchases by specified affiliates—

(A) In general—The acquisition of stock of a covered corporation by a specified affiliate of such covered corporation, from a person who is not the covered corporation or a specified affiliate of such covered corporation, shall be treated as a repurchase of the stock of the covered corporation by such covered corporation.

(B) Specified affiliate—For purposes of this section, the term "specified affiliate" means, with respect to any corporation—

(i) any corporation more than 50 percent of the stock of which is owned (by vote or by value), directly or indirectly, by such corporation, and

(ii) any partnership more than 50 percent of the capital interests or profits interests of which is held, directly or indirectly, by such corporation.

(3) Adjustment—The amount taken into account under subsection (a) with respect to any stock repurchased by a covered corporation shall be reduced by the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation during the taxable year, whether or not such stock is issued or provided in response to the exercise of an option to purchase such stock.

(d) Special rules for acquisition of stock of certain foreign corporations

(1) In general—In the case of an acquisition of stock of an applicable foreign corporation by a specified affiliate of such corporation (other than a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner)) from a person who is not the applicable foreign corporation or a specified affiliate of such applicable foreign corporation, for purposes of this section—

(A) such specified affiliate shall be treated as a covered corporation with respect to such acquisition,

(B) such acquisition shall be treated as a repurchase of stock of a covered corporation by such covered corporation, and

(C) the adjustment under subsection (c)(3) shall be determined only with respect to stock issued or provided by such specified affiliate to employees of the specified affiliate.

(2) Surrogate foreign corporations—In the case of a repurchase of stock of a covered surrogate foreign corporation by such covered surrogate foreign corporation, or an acquisition of stock of a covered surrogate foreign corporation by a specified affiliate of such corporation, for purposes of this section—

(A) the expatriated entity with respect to such covered surrogate foreign corporation shall be treated as a covered corporation with respect to such repurchase or acquisition,

(B) such repurchase or acquisition shall be treated as a repurchase of stock of a covered corporation by such covered corporation, and

(C) the adjustment under subsection (c)(3) shall be determined only with respect to stock issued or provided by such expatriated entity to employees of the expatriated entity.

(3) Definitions—For purposes of this subsection—

(A) Applicable foreign corporation—The term "applicable foreign corporation" means any foreign corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)).

(B) Covered surrogate foreign corporation—The term "covered surrogate foreign corporation" means any surrogate foreign corporation (as determined under section 7874(a)(2)(B) by substituting "September 20, 2021" for "March 4, 2003" each place it appears) the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)), but only with respect to taxable years which include any portion of the applicable period with respect to such corporation under section 7874(d)(1).

(C) Expatriated entity—The term "expatriated entity" has the meaning given such term by section 7874(a)(2)(A).

(e) Exceptions

Subsection (a) shall not apply—

(1) to the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 by reason of such reorganization,

(2) in any case in which the stock repurchased is, or an amount of stock equal to the value of the stock repurchased is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan,

(3) in any case in which the total value of the stock repurchased during the taxable year does not exceed $1,000,000,

(4) under regulations prescribed by the Secretary, in cases in which the repurchase is by a dealer in securities in the ordinary course of business,

(5) to repurchases by a regulated investment company (as defined in section 851) or a real estate investment trust, or

(6) to the extent that the repurchase is treated as a dividend for purposes of this title.

(f) Regulations and guidance

The Secretary shall prescribe such regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section, including regulations and other guidance—

(1) to prevent the abuse of the exceptions provided by subsection (e),

(2) to address special classes of stock and preferred stock, and

(3) for the application of the rules under subsection (d).

§7701. DEFINITIONS

(a)

When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) Person—The term "person" shall be construed to mean an+d include an individual, a trust, estate, partnership, association, company or corporation.

(2) Partnership and partner—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) Corporation—The term "corporation" includes associations, joint-stock companies, and insurance companies.

(4) Domestic—The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.

(5) Foreign—The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) Fiduciary—The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) Stock—The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) Shareholder—The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

(9) United States—The term "United States" when used in a geographical sense includes only the States and the District of Columbia.

(10) State—The term "State" shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.

(11) Secretary of the Treasury and Secretary—

(A) Secretary of the Treasury—The term "Secretary of the Treasury" means the Secretary of the Treasury, personally, and shall not include any delegate of his.

(B) Secretary—The term "Secretary" means the Secretary of the Treasury or his delegate.

(12) Delegate—

(A) In general—The term "or his delegate"—

(i) when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context; and

(ii) when used with reference to any other official of the United States, shall be similarly construed.

(B) Performance of certain functions in Guam or American Samoa—The term "delegate," in relation to the performance of functions in Guam or American Samoa with respect to the taxes imposed by chapters 1, 2, and 21, also includes any officer or employee of any other department or agency of the United States, or

of any possession thereof, duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform such functions.

(13) Commissioner—The term "Commissioner" means the Commissioner of Internal Revenue.

(14) Taxpayer—The term "taxpayer" means any person subject to any internal revenue tax.

(15) Military or naval forces and armed forces of the United States—The term "military or naval forces of the United States" and the term "Armed Forces of the United States" each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each term also includes the Coast Guard. The members of such forces include commissioned officers and personnel below the grade of commissioned officers in such forces.

(16) Withholding agent—The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 1441, 1442, 1443, or 1461.

(17) Husband and wife—As used in section 2516, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such section, the term "wife" shall be read "former wife" and the term "husband" shall be read "former husband"; and, if the payments described in such section are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such section, the term "husband" shall be read "wife" and the term "wife" shall be read "husband."

(18) International organization—The term "international organization" means a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288–288f).

(19) Domestic building and loan association—The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary,

(x) property used by the association in the conduct of the business described in subparagraph (B), and

(xi) any regular or residual interest in a REMIC, but only in the proportion which the assets of such REMIC consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC are assets described in clauses (i) through (x), the entire interest in the REMIC shall qualify.

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property. For purposes of determining whether any interest in a REMIC qualifies under clause (xi), any regular interest in another REMIC held by such REMIC shall be treated as a loan described in a preceding clause under principles similar to the principles of clause (xi); except that, if such REMIC's are part of a tiered structure, they shall be treated as 1 REMIC for purposes of clause (xi).

(20) Employee—For the purpose of applying the provisions of section 79 with respect to group-term life insurance purchased for employees, for the purpose of applying the provisions of sections 104, 105, and 106 with respect to accident and health insurance or accident and health plans, and for the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, and for purposes of applying section 125 with respect to cafeteria plans, the term "employee" shall include a full-time life insurance salesman who is considered an employee for the purpose of chapter 21.

(21) Levy—The term "levy" includes the power of distraint and seizure by any means.

(22) Attorney General—The term "Attorney General" means the Attorney General of the United States.

(23) Taxable year—The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the Secretary, the period for which such return is made.

(24) Fiscal year—The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December.

(25) Paid or incurred, paid or accrued—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A.

(26) Trade or business—The term "trade or business" includes the performance of the functions of a public office.

(27) Tax Court—The term "Tax Court" means the United States Tax Court.

(28) Other terms—Any term used in this subtitle with respect to the application of, or in connection with, the provisions of any other subtitle of this title shall have the same meaning as in such provisions.

(29) Internal Revenue Code—The term "Internal Revenue Code of 1986" means this title, and the term "Internal Revenue Code of 1939" means the Internal Revenue Code enacted February 10, 1939, as amended.

(30) United States person—The term "United States person" means—

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation,

(D) any estate (other than a foreign estate, within the meaning of paragraph (31)), and

(E) any trust if—

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.

(31) Foreign estate or trust—

(A) Foreign estate—The term "foreign estate" means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.

(B) Foreign trust—The term "foreign trust" means any trust other than a trust described in subparagraph (E) of paragraph (30).

(32) Cooperative bank—The term "cooperative bank" means an institution without capital stock organized and operated for mutual purposes and without profit, which—

(A) is subject by law to supervision and examination by State or Federal authority having supervision over such institutions, and

(B) meets the requirements of subparagraphs (B) and (C) of paragraph (19) of this subsection (relating to definition of domestic building and loan association).

In determining whether an institution meets the requirements referred to in subparagraph (B) of this paragraph, any reference to an association or to a domestic building and loan association contained in paragraph (19) shall be deemed to be a reference to such institution.

(33) Regulated public utility—The term "regulated public utility" means—

(A) A corporation engaged in the furnishing or sale of—

(i) electric energy, gas, water, or sewerage disposal services, or

(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) transportation (not included in clause (ii)) by motor vehicle—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission.

(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Surface Transportation Board, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Secretary of Transportation.

(F) A corporation engaged in the furnishing or sale of transportation by a water carrier subject to jurisdiction under subchapter II of chapter 135 of title 49.

(G) A rail carrier subject to part A of subtitle IV of title 49, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into before January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for

the taxable year is derived from such leases and from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, an agreement for lease of railroad properties entered into before January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into before January 1, 1954.

(H) A common parent corporation which is a common carrier by railroad subject to part A of subtitle IV of title 49 if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (G), received from a regulated public utility shall be considered as derived from sources described in subparagraphs (A) through (F), inclusive, if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

The term "regulated public utility" does not (except as provided in subparagraphs (G) and (H)) include a corporation described in subparagraphs (A) through (F), inclusive, unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in subparagraphs (A) through (F), inclusive. If the taxpayer establishes to the satisfaction of the Secretary that (i) its revenue from regulated rates described in subparagraph (A) or (D) and its revenue derived from unregulated rates are derived from the operation of a single interconnected and coordinated system or from the operation of more than one such system, and (ii) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, then such revenue from such unregulated rates shall be considered, for purposes of the preceding sentence, as income derived from sources described in subparagraph (A) or (D).

[(34) Repealed. Pub. L. 98–369, div. A, title IV, §4112(b)(11), July 18, 1984, 98 Stat. 792]—

(35) Enrolled actuary—The term "enrolled actuary" means a person who is enrolled by the Joint Board for the Enrollment of Actuaries established under subtitle C of the title III of the Employee Retirement Income Security Act of 1974.

(36) Tax return preparer—

(A) In general—The term "tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

(B) Exceptions—A person shall not be a "tax return preparer" merely because such person—

(i) furnishes typing, reproducing, or other mechanical assistance,

(ii) prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,

(iii) prepares as a fiduciary a return or claim for refund for any person, or

(iv) prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

(37) Individual retirement plan—The term "individual retirement plan" means—

(A) an individual retirement account described in section 408(a), and

(B) an individual retirement annuity described in section 408(b).

(38) Joint return—The term "joint return" means a single return made jointly under section 6013 by a husband and wife.

(39) Persons residing outside United States—If any citizen or resident of the United States does not reside in (and is not found in) any United States judicial district, such citizen or resident shall be treated as residing in the District of Columbia for purposes of any provision of this title relating to—

(A) jurisdiction of courts, or

(B) enforcement of summons.

(40) Indian tribal government—

(A) In general—The term "Indian tribal government" means the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary, after consultation with the Secretary of the Interior, to exercise governmental functions.

(B) Special rule for Alaska Natives—No determination under subparagraph (A) with respect to Alaska Natives shall grant or defer any status or powers other than those enumerated in section 7871. Nothing in the Indian Tribal Governmental Tax Status Act of 1982, or in the amendments made thereby, shall validate or invalidate any claim by Alaska Natives of sovereign authority over lands or people.

(41) TIN—The term "TIN" means the identifying number assigned to a person under section 6109.

(42) Substituted basis property—The term "substituted basis property" means property which is—

(A) transferred basis property, or

(B) exchanged basis property.

(43) Transferred basis property—The term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

(44) Exchanged basis property—The term "exchanged basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

(45) Nonrecognition transaction—The term "nonrecognition transaction" means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

(46) Determination of whether there is a collective bargaining agreement—In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term "employee representatives" shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer. An agreement shall not be treated as a

collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and 1 or more employers.

[(47) Repealed. Pub. L. 111–312, title III, §301(a), Dec. 17, 2010, 124 Stat. 3300]—

(48) Off-highway vehicles—

(A) Off-highway transportation vehicles—

(i) In general—A vehicle shall not be treated as a highway vehicle if such vehicle is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design such vehicle's capability to transport a load over the public highway is substantially limited or impaired.

(ii) Determination of vehicle's design—For purposes of clause (i), a vehicle's design is determined solely on the basis of its physical characteristics.

(iii) Determination of substantial limitation or impairment—For purposes of clause (i), in determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether such vehicle is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether such vehicle can transport a load at a sustained speed of at least 25 miles per hour. It is immaterial that a vehicle can transport a greater load off the public highway than such vehicle is permitted to transport over the public highway.

(B) Nontransportation trailers and semitrailers—A trailer or semitrailer shall not be treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an off-highway function at an off-highway site.

(49) Qualified blood collector organization—The term "qualified blood collector organization" means an organization which is—

(A) described in section 501(c)(3) and exempt from tax under section 501(a),

(B) primarily engaged in the activity of the collection of human blood,

(C) registered with the Secretary for purposes of excise tax exemptions, and

(D) registered by the Food and Drug Administration to collect blood.

(50) Termination of United States citizenship—

(A) In general—An individual shall not cease to be treated as a United States citizen before the date on which the individual's citizenship is treated as relinquished under section 877A(g)(4).

(B) Dual citizens—Under regulations prescribed by the Secretary, subparagraph (A) shall not apply to an individual who became at birth a citizen of the United States and a citizen of another country.

(51) Prohibited foreign entity—

(A) In general—

(i) Definition—The term "prohibited foreign entity" means a specified foreign entity or a foreign-influenced entity.

(ii) Determination—

(I) In general—Subject to subclause (II), for any taxable year, the determination as to whether an entity is a specified foreign entity or foreign-influenced entity shall be made as of the last day of such taxable year.

(II) Initial taxable year—For purposes of the first taxable year beginning after the date of enactment of this paragraph, the determination as to whether an entity is a specified foreign entity described in clauses (i) through (iv) of subparagraph (B) shall be made as of the first day of such taxable year.

(B) Specified foreign entity—For purposes of this paragraph, the term "specified foreign entity" means—

(i) a foreign entity of concern described in subparagraph (A), (B), (D), or (E) of section 9901(8) of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (Public Law 116–283; 15 U.S.C. 4651),

(ii) an entity identified as a Chinese military company operating in the United States in accordance with section 1260H of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (Public Law 116–283; 10 U.S.C. 113 note),

(iii) an entity included on a list required by clause (i), (ii), (iv), or (v) of section 2(d)(2)(B) of Public Law 117–78 (135 Stat. 1527),

(iv) an entity specified under section 154(b) of the National Defense Authorization Act for Fiscal Year 2024 (Public Law 118–31; 10 U.S.C. note prec. 4651), or

(v) a foreign-controlled entity.

(C) Foreign-controlled entity—For purposes of subparagraph (B), the term "foreign-controlled entity" means—

(i) the government (including any level of government below the national level) of a covered nation,

(ii) an agency or instrumentality of a government described in clause (i),

(iii) a person who is a citizen or national of a covered nation, provided that such person is not an individual who is a citizen, national, or lawful permanent resident of the United States,

(iv) an entity or a qualified business unit (as defined in section 989(a)) incorporated or organized under the laws of, or having its principal place of business in, a covered nation, or

(v) an entity (including subsidiary entities) controlled (as determined under subparagraph (G)) by an entity described in clause (i), (ii), (iii), or (iv).

(D) Foreign-influenced entity—

(i) In general—For purposes of subparagraph (A), the term "foreign-influenced entity" means an entity—

(I) with respect to which, during the taxable year—**(aa)** a specified foreign entity has the direct authority to appoint a covered officer of such entity, **(bb)** a single specified foreign entity owns at least 25 percent of such entity, **(cc)** one or more specified foreign entities own in the aggregate at least 40 percent of such entity, or **(dd)** at least 15 percent of the debt of such entity has been issued, in the aggregate, to 1 or more specified foreign entities, or

(II) which, during the previous taxable year, made a payment to a specified foreign entity pursuant to a contract, agreement, or other arrangement which entitles such specified foreign entity (or an entity related to such specified foreign entity) to exercise effective control over—**(aa)** any qualified facility or energy storage technology of the taxpayer (or any person related to the taxpayer), or **(bb)** with respect to any eligible component produced by the taxpayer (or any person related to the taxpayer)—**(AA)** the extraction, processing, or recycling of any applicable critical mineral, or **(BB)** the production of an eligible component which is not an applicable critical mineral.

(ii) Effective control—

(I) In general—**(aa) General rule**—Subject to subclause (II), for purposes of clause (i)(II), the term "effective control" means 1 or more agreements or arrangements similar to those described in subclauses (II) and (III) which provide 1 or more contractual counterparties of a taxpayer with specific authority over key aspects of the production of eligible components, energy generation in a qualified facility, or energy storage which are not included in the measures of control through authority, ownership, or debt held which are described in clause (i)(I). **(bb) Guidance**—The Secretary shall issue such guidance as is necessary to carry out the purposes of this clause, including the establishment of rules to prevent entities from evading, circumventing, or abusing the application of the restrictions described subparagraph (C) and subclauses (II) and (III) of this clause through a contract, agreement, or other arrangement.

(II) Application of rules prior to issuance of guidance—During any period prior to the date that the guidance described in subclause (I)(bb) is issued by the Secretary, for purposes of clause (i)(II), the term "effective control" means the unrestricted contractual right of a contractual counterparty to—**(aa)** determine the quantity or timing of production of an eligible component produced by the taxpayer, **(bb)** determine the amount or timing of activities related to the production of electricity undertaken at a qualified facility of the taxpayer or the storage of electrical energy in energy storage technology of the taxpayer, **(cc)** determine which entity may purchase or use the output of a production unit of the taxpayer that produces eligible components, **(dd)** determine which entity may purchase or use the output of a qualified facility of the taxpayer, **(ee)** restrict access to data critical to production or storage of energy undertaken at a qualified facility of the taxpayer, or to the site of production or any part of a qualified facility or energy storage technology of the taxpayer, to the personnel or agents of such contractual counterparty, or **(ff)** on an exclusive basis, maintain, repair, or operate any plant or equipment which is necessary to the production by the taxpayer of eligible components or electricity.

(III) Licensing and other agreements—**(aa) In general**—In addition to subclause (II), for purposes of clause (i)(II), the term "effective control" means, with respect to a licensing agreement for the provision of intellectual property (or any other contract, agreement or other arrangement entered into with a contractual counterparty related to such licensing agreement) with respect to a qualified facility, energy storage technology, or the production of an eligible component, any of the following:**(AA)** A contractual right retained by the contractual counterparty to specify or otherwise direct 1 or more sources of components, subcomponents, or applicable critical minerals utilized in a qualified facility, energy storage technology, or in the production of an eligible component. **(BB)** A contractual right retained by the contractual counterparty to direct the operation of any qualified facility, any energy storage technology, or any production unit that produces an eligible component. **(CC)** A contractual right retained by the contractual counterparty to limit the taxpayer's utilization of intellectual property related to the operation of a qualified facility or energy storage technology, or in the production of an eligible component. **(DD)** A contractual right retained by the contractual counterparty to receive royalties under the licensing agreement or any similar agreement (or payments under any related agreement) beyond the 10th year of the agreement (including modifications or extensions thereof). **(EE)** A contractual right

retained by the contractual counterparty to direct or otherwise require the taxpayer to enter into an agreement for the provision of services for a duration longer than 2 years (including any modifications or extensions thereof). **(FF)** Such contract, agreement, or other arrangement does not provide the licensee with all the technical data, information, and know-how necessary to enable the licensee to produce the eligible component or components subject to the contract, agreement, or other arrangement without further involvement from the contractual counterparty or a specified foreign entity. **(GG)** Such contract, agreement, or other arrangement was entered into (or modified) on or after the date of enactment of this paragraph. **(bb) Exception— (AA) In general**—Item (aa) shall not apply in the case of a bona fide purchase or sale of intellectual property. **(BB) Bona fide purchase or sale**—For purposes of item (aa), any purchase or sale of intellectual property where the agreement provides that ownership of the intellectual property reverts to the contractual counterparty after a period of time shall not be considered a bona-fide purchase or sale.

(IV) Persons related to the taxpayer—For purposes of subclauses (I), (II), and (III), the term "taxpayer" shall include any person related to the taxpayer.

(V) Contractual counterparty—For purposes of this clause, the term "contractual counterparty" means an entity with which the taxpayer has entered into a contract, agreement, or other arrangement.

(iii) Guidance—Not later than December 31, 2026, the Secretary shall issue such guidance as is necessary to carry out the purposes of this subparagraph, including establishment of rules to prevent entities from evading, circumventing, or abusing the application of the restrictions against impermissible technology licensing arrangements with specified foreign entities, such as through temporary transfers of intellectual property, retention by a specified foreign entity of a reversionary interest in transferred intellectual property, or otherwise.

(E) Publicly traded entities—

(i) In general—

(I) Nonapplication of certain foreign-controlled entity rules—Subparagraph (C)(v) shall not apply in the case of any entity the securities of which are regularly traded on—**(aa)** a national securities exchange which is registered with the Securities and Exchange Commission, **(bb)** the national market system established pursuant to section 11A of the Securities and1 Exchange Act of 1934, or **(cc)** any other exchange or other market which the Secretary has determined in guidance issued under section 1296(e)(1)(A)(ii) has rules adequate to carry out the purposes of part VI of subchapter P of chapter 1 of subtitle A.

(II) Nonapplication of certain foreign-influenced entity rules—Subparagraph (D)(i)(I) shall not apply in the case of any entity—**(aa)** the securities of which are regularly traded in a manner described in subclause (I), or **(bb)** for which not less than 80 percent of the equity securities of such entity are owned directly or indirectly by an entity which is described in item (aa).

(III) Exclusion of exchanges or markets in covered nations—Subclause (I)(cc) shall not apply with respect to any exchange or market which—**(aa)** is incorporated or organized under the laws of a covered nation, or **(bb)** has its principal place of business in a covered nation.

(ii) Additional foreign-controlled entity requirements for publicly traded companies—In the case of an entity described in clause (i)(I), such entity shall be deemed to be a foreign-controlled entity under subparagraph (C)(v) if such entity is controlled (as determined under subparagraph (G)) by—

(I) 1 or more specified foreign entities (as determined without regard to subparagraph (B)(v)) that are each required to report their beneficial ownership pursuant to a rule described in clause

(iii)(I)(bb), or

(II) 1 or more foreign-controlled entities (as determined without regard to subparagraph (C)(v)) that are each required to report their beneficial ownership pursuant to a rule described in such clause.

(iii) Additional foreign-influenced entity requirements for publicly traded companies—In the case of an entity described in clause (i)(II), such entity shall be deemed to be a foreign-influenced entity under subparagraph (D)(i)(I) if—

(I) during the taxable year—**(aa)** a specified foreign entity has the authority to appoint a covered officer of such entity, **(bb)** a single specified foreign entity required to report its beneficial ownership under Rule 13d-3 of the Securities and[1] Exchange Act of 1934 (or, in the case of an exchange or market described in clause (i)(I)(cc), an equivalent rule) owns not less than 25 percent of such entity, or **(cc)** 1 or more specified foreign entities that are each required to report their beneficial ownership under Rule 13d-3 of the Securities and[1] Exchange Act of 1934 own, in the aggregate, not less than 40 percent of such entity, or

(II) such entity has issued debt, as part of an original issuance, in excess of 15 percent of its publicly-traded debt to 1 or more specified foreign entities.

(F) Covered officer—For purposes of this paragraph, the term "covered officer" means, with respect to an entity—

(i) a member of the board of directors, board of supervisors, or equivalent governing body,

(ii) an executive-level officer, including the president, chief executive officer, chief operating officer, chief financial officer, general counsel, or senior vice president, or

(iii) an individual having powers or responsibilities similar to those of officers or members described in clause (i) or (ii).

(G) Determination of control—For purposes of subparagraph (C)(v), the term "control" means—

(i) in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation,

(ii) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership, or

(iii) in any other case, ownership of more than 50 percent of the beneficial interests in the entity.

(H) Determination of ownership—For purposes of this paragraph, section 318(a)(2) shall apply for purposes of determining ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity.

(I) Other definitions—For purposes of this paragraph—

(i) Applicable critical mineral—The term "applicable critical mineral" has the same meaning given such term under section 45X(c)(6).

(ii) Covered nation—The term "covered nation" has the same meaning given such term under section 4872(f)(2) of title 10, United States Code.

(iii) Eligible component—The term "eligible component" has the same meaning given such term under section 45X(c)(1).

(iv) Energy storage technology—The term "energy storage technology" has the same meaning given such term under section 48E(c)(2).

(v) Qualified facility—The term "qualified facility" means—

(I) a qualified facility, as defined in section 45Y(b)(1), and

(II) a qualified facility, as defined in section 48E(b)(3).

(vi) Related—The term "related" shall have the same meaning given such term under sections 267(b) and 707(b).

(J) Beginning of construction—For purposes of applying any provision under this paragraph, the beginning of construction with respect to any property shall be determined pursuant to rules similar to the rules under Internal Revenue Service Notice 2013–29 and Internal Revenue Service Notice 2018-59 (as well as any subsequently issued guidance clarifying, modifying, or updating either such Notice), as in effect on January 1, 2025.

(K) Regulations and guidance—The Secretary may prescribe such regulations and guidance as may be necessary or appropriate to carry out the provisions of this paragraph, including rules to prevent the circumvention of any rules or restrictions with respect to prohibited foreign entities.

(52) Material assistance from a prohibited foreign entity—

(A) In general—The term "material assistance from a prohibited foreign entity" means—

(i) with respect to any qualified facility or energy storage technology, a material assistance cost ratio which is less than the threshold percentage applicable under subparagraph (B), or

(ii) with respect to any facility which produces eligible components, a material assistance cost ratio which is less than the threshold percentage applicable under subparagraph (C).

(B) Threshold percentage for qualified facilities and energy storage technology—For purposes of subparagraph (A)(i), the threshold percentage shall be—

(i) in the case of a qualified facility the construction of which begins—

(I) during calendar year 2026, 40 percent,

(II) during calendar year 2027, 45 percent,

(III) during calendar year 2028, 50 percent,

(IV) during calendar year 2029, 55 percent, and

(V) after December 31, 2029, 60 percent, and

(ii) in the case of energy storage technology the construction of which begins—

(I) during calendar year 2026, 55 percent,

(II) during calendar year 2027, 60 percent,

(III) during calendar year 2028, 65 percent,

(IV) during calendar year 2029, 70 percent, and

(V) after December 31, 2029, 75 percent.

(C) Threshold percentage for eligible components—

(i) In general—For purposes of subparagraph (A)(ii), the threshold percentage shall be—

(I) in the case of any solar energy component (as such term is defined in section 45X(c)(3)(A)) which is sold—**(aa)** during calendar year 2026, 50 percent, **(bb)** during calendar year 2027, 60 percent, **(cc)** during calendar year 2028, 70 percent, **(dd)** during calendar year 2029, 80 percent, and **(ee)** after December 31, 2029, 85 percent,

(II) in the case of any wind energy component (as such term is defined in section 45X(c)(4)(A)) which is sold—**(aa)** during calendar year 2026, 85 percent, and **(bb)** during calendar year 2027, 90 percent,

(III) in the case of any inverter described in subparagraphs (B) through (G) of section 45X(c)(2) which is sold—**(aa)** during calendar year 2026, 50 percent, **(bb)** during calendar year 2027, 55 percent, **(cc)** during calendar year 2028, 60 percent, **(dd)** during calendar year 2029, 65 percent, and **(ee)** after December 31, 2029, 70 percent,

(IV) in the case of any qualifying battery component (as such term is defined in section 45X(c)(5)(A)) which is sold—**(aa)** during calendar year 2026, 60 percent, **(bb)** during calendar year 2027, 65 percent, **(cc)** during calendar year 2028, 70 percent, **(dd)** during calendar year 2029, 80 percent, and **(ee)** after December 31, 2029, 85 percent, and

(V) subject to clause (ii), in the case of any applicable critical mineral (as such term is defined in section 45X(c)(6)) which is sold—**(aa)** after December 31, 2025, and before January 1, 2030, 0 percent, **(bb)** during calendar year 2030, 25 percent, **(cc)** during calendar year 2031, 30 percent, **(dd)** during calendar year 2032, 40 percent, and **(ee)** after December 31, 2032, 50 percent.

(ii) Adjusted threshold percentage for applicable critical minerals—Not later than December 31, 2027, the Secretary shall issue threshold percentages for each of the applicable critical minerals described in section 45X(c)(6)), which shall—

(I) apply in lieu of the threshold percentage determined under clause (i)(V) for each calendar year, and

(II) equal or exceed the threshold percentage which would otherwise apply with respect to such applicable critical mineral under such clause for such calendar year, taking into account—**(aa)** domestic geographic availability, **(bb)** supply chain constraints, **(cc)** domestic processing capacity needs, and **(dd)** national security concerns.

(D) Material assistance cost ratio—

(i) Qualified facilities and energy storage technology—For purposes of subparagraph (A)(i), the term "material assistance cost ratio" means the amount (expressed as a percentage) equal to the quotient of—

(I) an amount equal to—**(aa)** the total direct costs to the taxpayer attributable to all manufactured products (including components) which are incorporated into the qualified facility or energy storage technology upon completion of construction, minus **(bb)** the total direct costs to the taxpayer attributable to all manufactured products (including components) which are—**(AA)** incorporated into the qualified facility or energy storage technology upon completion of construction, and **(BB)** mined, produced, or manufactured by a prohibited foreign entity, divided by

(II) the amount described in subclause (I)(aa).

(ii) Eligible components—For purposes of subparagraph (A)(ii), the term "material assistance cost ratio" means the amount (expressed as a percentage) equal to the quotient of—

(I) an amount equal to—**(aa)** with respect to an eligible component, the total direct material costs that are paid or incurred (within the meaning of section 461 and any regulations issued under section 263A) by the taxpayer for production of such eligible component, minus **(bb)** with respect to an eligible component, the total direct material costs that are paid or incurred (within the meaning of section 461 and any regulations issued under section 263A) by the taxpayer for production of such eligible component that are mined, produced, or manufactured by a prohibited foreign entity, divided by

(II) the amount described in subclause (I)(aa).

(iii) Safe harbor tables—

(I) In general—Not later than December 31, 2026, the Secretary shall issue safe harbor tables (and such other guidance as deemed necessary) to—**(aa)** identify the percentage of total direct costs of any manufactured product which is attributable to a prohibited foreign entity, **(bb)** identify the percentage of total direct material costs of any eligible component which is attributable to a prohibited foreign entity, and **(cc)** provide all rules necessary to determine the amount of a taxpayer's material assistance from a prohibited foreign entity within the meaning of this paragraph.

(II) Safe harbors prior to issuance—For purposes of this paragraph, prior to the date on which the Secretary issues the safe harbor tables described in subclause (I), and for construction of a qualified facility or energy storage technology which begins on or before the date which is 60 days after the date of issuance of such tables, a taxpayer may—**(aa)** use the tables included in Internal Revenue Service Notice 2025–08 to establish the percentage of the total direct costs of any listed eligible component and any manufactured product, and **(bb)** rely on a certification by the supplier of the manufactured product, eligible component, or constituent element, material, or subcomponent of an eligible component—**(AA)** of the total direct costs or the total direct material costs, as applicable, of such product or component that was not produced or manufactured by a prohibited foreign entity, or **(BB)** that such product or component was not produced or manufactured by a prohibited foreign entity.

(III) Exception—Notwithstanding subclauses (I) and (II)—**(aa)** if the taxpayer knows (or has reason to know) that a manufactured product or eligible component was produced or manufactured by a prohibited foreign entity, the taxpayer shall treat all direct costs with respect to such manufactured product, or all direct material costs with respect to such eligible component, as attributable to a prohibited foreign entity, and **(bb)** if the taxpayer knows (or has reason to know) that the certification referred to in subclause (II)(bb) pertaining to a manufactured product or eligible component is inaccurate, the taxpayer may not rely on such certification.

(IV) Certification requirement—In a manner consistent with Treasury Regulation section 1.45X–4(c)(4)(i) (as in effect on the date of enactment of this paragraph), the certification referred to in subclause (II)(bb) shall—**(aa)** include—**(AA)** the supplier's employer identification number, or **(BB)** any such similar identification number issued by a foreign government, **(bb)** be signed under penalties of perjury, **(cc)** be retained by the supplier and the taxpayer for a period of not less than 6 years and shall be provided to the Secretary upon request, and **(dd)** be from the supplier from which the taxpayer purchased any manufactured product, eligible component, or constituent elements, materials, or subcomponents of an eligible component, stating—**(AA)** that such property was not produced or manufactured by a prohibited foreign entity and that the supplier does not

know (or have reason to know) that any prior supplier in the chain of production of that property is a prohibited foreign entity, **(BB)** for purposes of section 45X, the total direct material costs for each component, constituent element, material, or subcomponent that were not produced or manufactured by a prohibited foreign entity, or **(CC)** for purposes of section 45Y or section 48E, the total direct costs attributable to all manufactured products that were not produced or manufactured by a prohibited foreign entity.

(iv) Existing contract—Upon the election of the taxpayer (in such form and manner as the Secretary shall designate), in the case of any manufactured product, eligible component, or constituent element, material, or subcomponent of an eligible component which is—

(I) acquired by the taxpayer, or manufactured or assembled by or for the taxpayer, pursuant to a binding written contract which was entered into prior to June 16, 2025, and

(II)(aa) placed into service before January 1, 2030 (or, in the case of an applicable facility, as defined in section 45Y(d)(4)(B), before January 1, 2028) in a facility the construction of which began before August 1, 2025, or **(bb)** in the case of a constituent element, material, or subcomponent, used in a product sold before January 1, 2030,

the cost to the taxpayer with respect to such product, component, element, material, or subcomponent shall not be included for purposes of determining the material assistance cost ratio under this subparagraph.

(v) Anti-circumvention rules—The Secretary shall prescribe such regulations and guidance as may be necessary or appropriate to prevent circumvention of the rules under this subparagraph, including prevention of—

(I) any abuse of the exception provided under clause (iv) through the stockpiling of any manufactured product, eligible component, or constituent element, material, or subcomponent of an eligible component during any period prior to the application of the requirements under this paragraph, or

(II) any evasion with respect to the requirements of this subparagraph where the facts and circumstances demonstrate that the beginning of construction of a qualified facility or energy storage technology has not in fact occurred.

(E) Other definitions—For purposes of this paragraph—

(i) Eligible component—The term "eligible component" means—

(I) any property described in section 45X(c)(1), or

(II) any component which is identified by the Secretary pursuant to regulations or guidance issued under subparagraph (G).

(ii) Energy storage technology—The term "energy storage technology" has the same meaning given such term under section 48E(c)(2).

(iii) Manufactured product—The term "manufactured product" means—

(I) a manufactured product which is a component of a qualified facility, as described in section 45Y(g)(11)(B) and any guidance issued thereunder, or

(II) any product which is identified by the Secretary pursuant to regulations or guidance issued under subparagraph (G).

(iv) Qualified facility—The term "qualified facility" means—

(I) a qualified facility, as defined in section 45Y(b)(1),

(II) a qualified facility, as defined in section 48E(b)(3), and

(III) any qualified interconnection property (as defined in section 48E(b)(4)) which is part of the qualified investment with respect to a qualified facility (as described in section 48E(b)(1)).

(F) Determination of ownership; beginning of construction—Rules similar to the rules under subparagraphs (H) and (J) of paragraph (51) shall apply for purposes of this paragraph.

(G) Regulations and guidance—The Secretary may prescribe such regulations and guidance as may be necessary or appropriate to carry out the provisions of this paragraph, including—

(i) identification of components or products for purposes of clauses (i) and (iii) of subparagraph (E), and

(ii) for purposes of subparagraph (A)(ii), rules to address facilities which produce more than one eligible component.

§7704. CERTAIN PUBLICLY TRADED PARTNERSHIPS TREATED AS CORPORATIONS

(a) General rule

For purposes of this title, except as provided in subsection (c), a publicly traded partnership shall be treated as a corporation.

(b) Publicly traded partnership

For purposes of this section, the term "publicly traded partnership" means any partnership if—

(1) interests in such partnership are traded on an established securities market, or

(2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

(c) Exception for partnerships with passive-type income

(1) In general—Subsection (a) shall not apply to any publicly traded partnership for any taxable year if such partnership met the gross income requirements of paragraph (2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. For purposes of the preceding sentence, a partnership shall not be treated as being in existence during any period before the 1st taxable year in which such partnership (or a predecessor) was a publicly traded partnership.

(2) Gross income requirements—A partnership meets the gross income requirements of this paragraph for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income.

(3) Exception not to apply to certain partnerships which could qualify as regulated investment companies—This subsection shall not apply to any partnership which would be described in section 851(a) if such partnership were a domestic corporation. To the extent provided in regulations, the preceding sentence shall not apply to any partnership a principal activity of which is the buying and selling of commodities (not

described in section 1221(a)(1)), or options, futures, or forwards with respect to commodities.

(f) Effect of becoming corporation

As of the 1st day that a partnership is treated as a corporation under this section, for purposes of this title, such partnership shall be treated as—

(1) transferring all of its assets (subject to its liabilities) to a newly formed corporation in exchange for the stock of the corporation, and

(2) distributing such stock to its partners in liquidation of their interests in the partnership.

Code of Federal Regulations

Title 26

Selected Sections

§1.118-1 Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

§1.301-1 Rules applicable with respect to distributions of money and other property.

(h) *Transfers for less than fair market value.* If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, such shareholder is treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution is the excess of the fair market value of the property over the amount paid for such property at the time of the transfer. For example, on January 3, 2021, A, a shareholder of Corporation X, purchased property from X for $20 when the fair market value of such property was $100. The amount of the distribution to A determined under section 301(b) is $80.

§1.302-1 General.

(a) Under section 302(d), unless otherwise provided in subchapter C, chapter 1 of the Code, a distribution in redemption of stock shall be treated as a distribution of property to which section 301 applies if the distribution is not within any of the provisions of section 302(b). A distribution in redemption of stock shall be considered a distribution in part or full payment in exchange for the stock under section 302(a) provided paragraph (1), (2), (3), or (4) of section 302(b) applies. Section 318(a) (relating to constructive ownership of stock) applies to all redemptions under section 302 except that in the termination of a shareholder's interest certain limitations are placed on the application of section 318(a)(1) by section 302(c)(2). The term *redemption of stock* is defined in section 317(b). Section 302 does not apply to that portion of any distribution which qualifies as a distribution in partial liquidation under section 346. For special rules relating to redemption of stock to pay death taxes see section 303. For special rules relating to redemption of section 306 stock see section 306. For special rules relating to redemption of stock in partial or complete liquidation see section 331.

§1.302-2 Redemptions not taxable as dividends.

(a) *In general.* The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the

requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) *Redemption not essentially equivalent to a dividend —*

(1) *In general.* The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 302(e). The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. Distributions in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise.

(2) *Statement.* Unless §1.331-1(d) applies, every significant holder that transfers stock to the issuing corporation in exchange for property from such corporation must include on or with such holder's return for the taxable year of such exchange a statement entitled, "STATEMENT PURSUANT TO §1.302-2(b)(2) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER OF THE STOCK OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF ISSUING CORPORATION]." If a significant holder is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The statement must include—

(i) The fair market value and basis of the stock transferred by the significant holder to the issuing corporation; and

(ii) A description of the property received by the significant holder from the issuing corporation.

(3) *Definitions.* For purposes of this section:

(i) *Significant holder* means any person that, immediately before the exchange—

(A) Owned at least five percent (by vote or value) of the total outstanding stock of the issuing corporation if the stock owned by such person is publicly traded; or

(B) Owned at least one percent (by vote or value) of the total outstanding stock of the issuing corporation if the stock owned by such person is not publicly traded.

(ii) *Publicly traded stock* means stock that is listed on—

(A) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(B) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3).

(iii) *Issuing corporation* means the corporation that issued the shares of stock, some or all of which were transferred by a significant holder to such corporation in the exchange described in paragraph (b)(2) of this section.

(4) *Cross reference.* See section 6043 of the Internal Revenue Code for requirements relating to a return by a liquidating corporation.

(c) *Basis adjustments.* In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. (For adjustments to basis required for certain redemptions of corporate shareholders that are treated as extraordinary dividends, see section 1059 and the regulations thereunder.) The following examples illustrate the application of this rule:

Example 1. A, an individual, purchased all of the stock of Corporation X for $100,000. In 1955 the corporation redeems half of the stock for $150,000, and it is determined that this amount constitutes a dividend. The remaining stock of Corporation X held by A has a basis of $100,000.

Example 2. H and W, husband and wife, each own half of the stock of Corporation X. All of the stock was purchased by H for $100,000 cash. In 1950 H gave one-half of the stock to W, the stock transferred having a value in excess of $50,000. In 1955 all of the stock of H is redeemed for $150,000, and it is determined that the distribution to H in redemption of his shares constitutes the distribution of a dividend. Immediately after the transaction, W holds the remaining stock of Corporation X with a basis of $100,000.

Example 3. The facts are the same as in *Example (2)* with the additional facts that the outstanding stock of Corporation X consists of 1,000 shares and all but 10 shares of the stock of H is redeemed. Immediately after the transaction, H holds 10 shares of the stock of Corporation X with a basis of $50,000, and W holds 500 shares with a basis of $50,000.

(d) *Effective/applicability date.* Paragraphs (b)(2), (b)(3) and (b)(4) of this section apply to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply paragraphs (b)(2), (b)(3) and (b)(4) of this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see §1.302-2 as contained in 26 CFR part 1 in effect on April 1, 2006.

§1.302-3 Substantially disproportionate redemption.

(a) Section 302(b)(2) provides for the treatment of an amount received in redemption of stock as an amount received in exchange for such stock if—

(1) Immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock as provided in section 302(b)(2)(B),

(2) The redemption is a substantially disproportionate redemption within the meaning of section 302(b)(2)(C), and

(3) The redemption is not pursuant to a plan described in section 302(b)(2)(D).

Section 318(a) (relating to constructive ownership of stock) shall apply both in making the disproportionate redemption test and in determining the percentage of stock ownership after the redemption. The requirements under section 302(b)(2) shall be applied to each shareholder separately and shall be applied only with respect to stock which is issued and outstanding in the hands of the shareholders. Section 302(b)(2) only applies to a redemption of voting stock or to a redemption of both voting stock and other stock. Section 302(b)(2) does not apply to the redemption solely of nonvoting stock (common or preferred). However, if a redemption is treated as an exchange to a particular shareholder under the terms of section 302(b)(2), such section will apply to the simultaneous redemption of nonvoting preferred stock (which is not section 306 stock) owned by such shareholder and such redemption will also be treated as an exchange. Generally, for purposes of this section, stock which does not have voting rights until the happening of an event, such as a default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Subsection 302(b)(2)(D) provides that a redemption will not be treated as substantially disproportionate if made pursuant to a plan the purpose or effect of which is a series of redemptions which result in the aggregate in a distribution which is not substantially disproportionate. Whether or not such a plan exists will be determined from all the facts and circumstances.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example. Corporation M has outstanding 400 shares of common stock of which A, B, C and D each own 100 shares or 25 percent. No stock is considered constructively owned by A, B, C or D under section 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C. For the redemption to be disproportionate as to any shareholder, such shareholder must own after the redemptions less than 20 percent (80 percent of 25 percent) of the 300 shares of stock then outstanding. After the redemptions, A owns 45 shares (15 percent), B owns 75 shares (25 percent), and C owns 80 shares (26⅔ percent). The distribution is disproportionate only with respect to A.

§1.302-4 Termination of shareholder's interest.

Section 302(b)(3) provides that a distribution in redemption of all of the stock of the corporation owned by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock of such shareholder. In determining whether all of the stock of the shareholder has been redeemed, the general rule of section 302(c)(1) requires that the rules of constructive ownership provided in section 318(a) shall apply. Section 302(c)(2), however, provides that section 318(a)(1) (relating to constructive ownership of stock owned by members of a family) shall not apply where the specific requirements of section 302(c)(2) are met. The following rules shall be applicable in determining whether the specific requirements of section 302(c)(2) are met:

(a) *Statement.* The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a statement entitled, "STATEMENT PURSUANT TO SECTION 302(c)(2)(A)(iii) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER OR RELATED PERSON, AS THE CASE MAY BE], A DISTRIBUTEE (OR RELATED PERSON) OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF DISTRIBUTING CORPORATION]." The distributee must include such statement on or with the distributee's first return for the taxable year in which the distribution described in section 302(b)(3) occurs. If the distributee is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The distributee must represent in the statement—

(1) THE DISTRIBUTEE (OR RELATED PERSON) HAS NOT ACQUIRED, OTHER THAN BY BEQUEST OR INHERITANCE, ANY INTEREST IN THE CORPORATION (AS DESCRIBED IN SECTION 302(c)(2)(A)(i)) SINCE THE DISTRIBUTION; and

(2) THE DISTRIBUTEE (OR RELATED PERSON) WILL NOTIFY THE INTERNAL REVENUE SERVICE OF ANY ACQUISITION, OTHER THAN BY BEQUEST OR INHERITANCE, OF SUCH AN INTEREST IN THE CORPORATION WITHIN 30 DAYS AFTER THE ACQUISITION, IF THE ACQUISITION OCCURS WITHIN 10 YEARS FROM THE DATE OF THE DISTRIBUTION.

(b) *Substantiation information.* The distributee who files an agreement under section 302(c)(2)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.

(c) *Stock of parent, subsidiary or successor corporation redeemed.* If stock of a parent corporation is redeemed, section 302(c)(2)(A), relating to acquisition of an interest in the corporation within 10 years after termination shall be applied with reference to an interest both in the parent corporation and any subsidiary of such parent corporation. If stock of a parent corporation is sold to a subsidiary in a transaction described in section 304, section 302(c)(2)(A) shall be applicable to the acquisition of an interest in such subsidiary corporation or in the parent corporation. If stock of a subsidiary corporation is redeemed, section 302(c)(2)(A) shall be applied with reference to an interest both in such subsidiary corporation and its parent. Section 302(c)(2)(A) shall also be applied with respect to an interest in a corporation which is a successor corporation to the corporation the interest in which has been terminated.

(d) *Redeemed shareholder as creditor.* For the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

(e) *Acquisition of assets pursuant to creditor's rights.* In the case of a distributee to whom section 302(b)(3) is applicable, who is a creditor after such transaction, the acquisition of the assets of the corporation in the enforcement of the rights of such creditor shall not be considered an acquisition of an interest in the corporation for purposes of section 302(c)(2) unless stock of the corporation, its parent corporation, or, in the case of a redemption of stock of a parent corporation, of a subsidiary of such corporation is acquired.

(f) *Constructive ownership rules applicable.* In determining whether an entire interest in the corporation has been terminated under section 302(b)(3), under all circumstances paragraphs (2), (3), (4), and (5) of section 318(a) (relating to constructive ownership of stock) shall be applicable.

(g) *Avoidance of Federal income tax.* Section 302(c)(2)(B) provides that section 302(c)(2)(A) shall not apply—

(1) If any portion of the stock redeemed was acquired directly or indirectly within the 10-year period ending on the date of the distribution by the distributee from a person, the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(2) If any person owns (at the time of the distribution) stock, the ownership of which is attributable to the distributee under section 318(a), such person acquired any stock in the corporation directly or indirectly from the distributee within the 10-year period ending on the date of the distribution, and such stock so acquired from the distributee is not redeemed in the same transaction,unless the acquisition (described in subparagraph (1) of this paragraph) or the disposition by the distributee (described in subparagraph (2) of this paragraph) did not have as one of its principal purposes the avoidance of Federal income tax. A transfer of stock by the transferor,

within the 10-year period ending on the date of the distribution, to a person whose stock would be attributable to the transferor shall not be deemed to have as one of its principal purposes the avoidance of Federal income tax merely because the transferee is in a lower income tax bracket than the transferor.

(h) *Effective/applicability date.* Paragraph (a) of this section applies to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply paragraph (a) of this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see §1.302-4 as contained in 26 CFR part 1 in effect on April 1, 2006.

(Sec. 302(c)(2)(A)(iii) (68A Stat. 87; 26 U.S.C. 302 (c)(2)(A)(iii)))

§1.304-2 Acquisition by related corporation (other than subsidiary).

(a) If a corporation, in return for property, acquires stock of another corporation from one or more persons, and the person or persons from whom the stock was acquired were in control of both such corporations before the acquisition, then such property shall be treated as received in redemption of stock of the acquiring corporation. The stock received by the acquiring corporation shall be treated as a contribution to the capital of such corporation. See section 362(a) for determination of the basis of such stock. The transferor's basis for his stock in the acquiring corporation shall be increased by the basis of the stock surrendered by him. (But see below in this paragraph for subsequent reductions of basis in certain cases.) As to each person transferring stock, the amount received shall be treated as a distribution of property under section 302(d), unless as to such person such amount is to be treated as received in exchange for the stock under the terms of section 302(a) or section 303. In applying section 302(b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to his ownership of stock in the acquiring corporation (except for purposes of applying section 318(a)). In determining control and applying section 302(b), section 318(a) (relating to the constructive ownership of stock) shall be applied without regard to the 50-percent limitation contained in section 318(a)(2)(C) and (3)(C). A series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations. If section 302(d) applies to the surrender of stock by a shareholder, his basis for his stock in the acquiring corporation after the transaction (increased as stated above in this paragraph) shall not be decreased except as provided in section 301. If section 302(d) does not apply, the property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under section 302(a), which stock has a basis equal to the amount by which the shareholder's basis for his stock in the acquiring corporation was increased on account of the contribution to capital as provided for above in this paragraph. Accordingly, such amount shall be applied in reduction of the shareholder's basis for his stock in the acquiring corporation. Thus, the basis of each share of the shareholder's stock in the acquiring corporation will be the same as the basis of such share before the entire transaction. The holding period of the stock which is considered to have been redeemed shall be the same as the holding period of the stock actually surrendered.

(b) In any case in which two or more persons, in the aggregate, control two corporations, section 304(a)(1) will apply to sales by such persons of stock in either corporation to the other (whether or not made simultaneously) provided the sales by each of such persons are related to each other. The determination of whether the sales are related to each other shall be dependent upon the facts and circumstances surrounding all of the sales. For this purpose, the fact that the sales may occur during a period of one or more years (such as in the case of a series of sales by persons who together control each of such corporations immediately prior to the first of such sales and immediately subsequent to the last of such sales) shall be disregarded, provided the other facts and circumstances indicate related transactions.

(c) The application of section 304(a)(1) may be illustrated by the following examples:

Example 1. Corporation X and corporation Y each have outstanding 200 shares of common stock. One-half of the stock of each corporation is owned by an individual, A, and one-half by another individual, B, who is unrelated to A. On or after August 31, 1964, A sells 30 shares of corporation X stock to corporation Y for $50,000, such stock having an adjusted basis of $10,000 to A. After the sale, A is considered as owning corporation X stock as follows: (i) 70 shares directly, and (ii) 15 shares constructively, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 30 shares owned directly by Y. Since A's percentage of ownership of X's voting stock after the sale (85 out of 200 shares, or 42.5%) is not less than 80 percent of his percentage of ownership of X's voting stock before the sale (100 out of 200 shares, or 50%), the transfer is not "substantially disproportionate" as to him as provided in section 302(b)(2). Under these facts, and assuming that section 302(b)(1) is not applicable, the entire $50,000 is treated as a dividend to A to the extent of the earnings and profits of corporation Y. The basis of the corporation X stock to corporation Y is $10,000, its adjusted basis to A. The amount of $10,000 is added to the basis of the stock of corporation Y in the hands of A.

Example 2. The facts are the same as in *Example (1)* except that A sells 80 shares of corporation X stock to corporation Y, and the sale occurs before August 31, 1964. After the sale, A is considered as owning corporation X stock as follows: (i) 20 shares directly, and (ii) 90 shares indirectly, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 80 shares owned directly by Y and 50 percent of the 100 shares attributed to Y because they are owned by Y's stockholder, B. Since after the sale A owns a total of more than 50 percent of the voting power of all of the outstanding stock of X (110 out of 200 shares, or 55%), the transfer is not "substantially disproportionate" as to him as provided in section 302(b)(2).

§1.304-3 Acquisition by a subsidiary.

(a) If a subsidiary acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as though the parent corporation had redeemed its own stock. For the purpose of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. If such distribution would have been treated as a distribution of property (pursuant to section 302(d)) under section 301, the entire amount of the selling price of the stock shall be treated as a dividend to the seller to the extent of the earnings and profits of the parent corporation determined as if the distribution had been made to it of the property that the subsidiary exchanged for the stock. In such cases, the transferor's basis for his remaining stock in the parent corporation will be determined by including the amount of the basis of the stock of the parent corporation sold to the subsidiary.

(b) Section 304(a)(2) may be illustrated by the following example:

§1.304-5 Control.

(a) *Control requirement in general.* Section 304(c)(1) provides that, for purposes of section 304, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Section 304(c)(3) makes section 318(a) (relating to constructive ownership of stock), as modified by section 304(c)(3)(B), applicable to section 304 for purposes of determining control under section 304(c)(1).

(b) *Effect of section 304(c)(2)(B) —*

(1) *In general.* In determining whether the control test with respect to both the issuing and acquiring corporations is satisfied, section 304(a)(1) considers only the person or persons that—

(i) Control the issuing corporation before the transaction;

(ii) Transfer issuing corporation stock to the acquiring corporation for property; and

(iii) Control the acquiring corporation thereafter.

(2) *Application.* Section 317 defines property to include money, securities, and any other property except stock (or stock rights) in the distributing corporation. However, section 304(c)(2)(B) provides a special rule to extend the relevant group of persons to be tested for control of both the issuing and acquiring corporations to include the person or persons that do not acquire property, but rather solely stock from the acquiring corporation in the transaction. Section 304(c)(2)(B) provides that if two or more persons in control of the issuing corporation transfer stock of such corporation to the acquiring corporation, and if the transferors are in control of the acquiring corporation after the transfer, the person or persons in control of each corporation include each of those transferors. Because the purpose of section 304(c)(2)(B) is to include in the relevant control group the person or persons that retain or acquire acquiring corporation stock in the transaction, only the person or persons transferring stock of the issuing corporation that retain or acquire any proprietary interest in the acquiring corporation are taken into account for purposes of applying section 304(c)(2)(B).

(3) *Example.* This section may be illustrated by the following example.

Example.

(a) A, the owner of 20% of T's only class of stock, transfers that stock to P solely in exchange for all of the P stock. Pursuant to the same transaction, P, solely in exchange for cash, acquires the remaining 80% of the T stock from T's other shareholder, B, who is unrelated to A and P.

(b) Although A and B together were in control of T (the issuing corporation) before the transaction and A and B each transferred T stock to P (the acquiring corporation), sections 304(a)(1) and (c)(2)(B) do not apply to B because B did not retain or acquire any proprietary interest in P in the transaction. Section 304(a)(1) also does not apply to A because A (or any control group of which A was a member) did not control T before the transaction and P after the transaction.

(c) *Effective date.* This section is effective on January 20, 1994.

§1.305-1 Stock dividends.

(a) *In general.* Under section 305, a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under the authority of section 305(c). A distribution made by a corporation to its shareholders in its stock or rights to acquire its stock which would not otherwise be included in gross income by reason of section 305 shall not be so included merely because such distribution was made out of Treasury stock or consisted of rights to acquire Treasury stock. See section 307 for rules as to basis of stock and stock rights acquired in a distribution.

(b) *Amount of distribution.*

(1) In general, where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b), the amount of the distribution, in accordance with section 301(b) and § 1.301-1, is the fair market value of such stock or rights on the date of distribution. See *Example (1)* of § 1.305-2(b).

(2) Where a corporation which regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of the stock received by any shareholder electing to receive stock will be considered to equal the amount of the money which could have been received instead. See *Example (2)* of § 1.305-2(b).

(3) For rules for determining the amount of the distribution where certain transactions, such as changes in conversion ratios or periodic redemptions, are treated as distributions under section 305(c), see *Examples (6), (8), (9), and (15)* of § 1.305-3(e).

§1.305-2 Distributions in lieu of money.

(a) *In general.* Under section 305(b)(1), if any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in the other;

(4) Whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

(5) Whether all or part of the shareholders have the election.

(b) *Examples.* The application of section 305(b)(1) may be illustrated by the following examples:

Example 1.

(i) Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus $12 principal amount of securities of corporation Y owned by corporation X. The fair market value of the stock of corporation X on the distribution date was $10 per share. The fair market value of $12 principal amount of securities of corporation Y on the distribution date was $11 but such securities had a cost basis to corporation X of $9.

(ii) The distribution to all shareholders of one additional share of stock of corporation X (with respect to which no election applies) for each share outstanding is not a distribution to which section 301 applies.

(iii) The distribution of the second share of stock of corporation X to those shareholders who do not elect to receive securities of corporation Y is a distribution of property to which section 301 applies, whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies is $10 per share of stock of corporation X held on the record date (the fair market value of the stock of corporation X on the distribution date).

(iv) The distribution of securities of corporation Y in lieu of the second share of stock of corporation X to the shareholders of corporation X whether individuals or corporations, who elect to receive such securities, is also a distribution of property to which section 301 applies.

(v) In the case of the individual shareholders of corporation X who elects to receive such securities, the amount of the distribution to which section 301 applies is $11 per share of stock of corporation X held on the record date (the fair market value of the $12 principal amount of securities of corporation Y on the distribution date).

(vi) In the case of the corporate shareholders of corporation X electing to receive such securities, the amount of the distribution to which section 301 applies is $9 per share of stock of corporation X held on the record date (the basis of the securities of corporation Y in the hands of corporation X).

Example 2. On January 10, 1970, corporation X, a regulated investment company, declared a dividend of $1 per share on its common stock payable on February 11, 1970, in cash or in stock of corporation X of equivalent value determined as of January 22, 1970, at the election of the shareholder made on or before January 22, 1970. The amount of the distribution to which section 301 applies is $1 per share whether the shareholder elects to take cash or stock and whether the shareholder is an individual or a corporation. Such amount will also be used in determining the dividend paid deduction of corporation X and the reduction in earnings and profits of corporation X.

§1.305-3 Disproportionate distributions.

(a) *In general.* Under section 305(b)(2), a distribution (including a deemed distribution) by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of

(1) the receipt of money or other property by some shareholders, and

(2) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Thus, if a corporation has two classes of common stock outstanding and cash dividends are paid on one class and stock dividends are paid on the other class, the stock dividends are treated as distributions to which section 301 applies.

(b) *Special rules.*

(1) As used in section 305(b)(2), the term *a series of distributions* encompasses all distributions of stock made or deemed made by a corporation which have the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders.

(2) In order for a distribution of stock to be considered as one of a series of distributions it is not necessary that such distribution be pursuant to a plan to distribute cash or property to some shareholders and to increase the proportionate interests of other shareholders. It is sufficient if there is an actual or deemed distribution of stock (of which such distribution is one) and as a result of such distribution or distributions some shareholders receive cash or property and other shareholders increase their proportionate interests. For example, if a corporation pays quarterly stock dividends to one class of common shareholders and annual cash dividends to another class of common shareholders the quarterly stock dividends constitute a series of distributions of stock having the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders. This is so whether or not the stock distributions and the cash distributions are steps in an overall plan or are independent and unrelated. Accordingly, all the quarterly stock dividends are distributions to which section 301 applies.

(3) There is no requirement that both elements of section 305(b)(2) (i.e., receipt of cash or property by some shareholders and an increase in proportionate interests of other shareholders) occur in the form of a distribution or series of distributions as long as the result of a distribution or distributions of stock is that some shareholders' proportionate interests increase and other shareholders in fact receive cash or property. Thus, there is no requirement that the shareholders receiving cash or property acquire the cash or property by way of a corporate distribution with respect to their shares, so long as they receive such cash or property in their capacity as shareholders, if there is a stock distribution which results in a change in the proportionate interests of some shareholders and other shareholders receive cash or property. However, in order for a distribution of property to meet the requirement of section 305(b)(2), such distribution must be made to a shareholder in his capacity as a shareholder, and must be a distribution to which section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) applies. (Under section 305(d)(2), the payment of interest to a holder of a convertible debenture is treated as a distribution of property to a shareholder for purposes of section 305(b)(2).) For example if a corporation makes a stock distribution to its shareholders and, pursuant to a prearranged plan with such corporation, a related corporation purchases such stock from those shareholders who want cash, in a transaction to which section 301 applies by virtue of section 304, the requirements of section 305(b)(2) are satisfied. In addition, a distribution of property incident to an isolated redemption of stock (for example, pursuant to a tender offer) will not cause section 305(b)(2) to apply even though the redemption distribution is treated as a distribution of property to which section 301, 871(a)(1)(A), 881(a)(1), or 356(a)(2) applies.

(4) Where the receipt of cash or property occurs more than 36 months following a distribution or series of distributions of stock, or where a distribution or series of distributions of stock is made more than 36 months following the receipt of cash or property, such distribution or distributions will be presumed not to result in the receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders, unless the receipt of cash or property and the distribution or series of distributions of stock are made pursuant to a plan. For example, if, pursuant to a plan, a corporation pays cash dividends to some shareholders on January 1, 1971 and increases the proportionate interests of other shareholders on March 1, 1974, such increases in proportionate interests are distributions to which section 301 applies.

(5) In determining whether a distribution or a series of distributions has the result of a disproportionate distribution, there shall be treated as outstanding stock of the distributing corporation

(i) any right to acquire such stock (whether or not exercisable during the taxable year), and

(ii) any security convertible into stock of the distributing corporation (whether or not convertible during the taxable year).

(6) In cases where there is more than one class of stock outstanding, each class of stock is to be considered separately in determining whether a shareholder has increased his proportionate interest in the assets or earnings and profits of a corporation. The individual shareholders of a class of stock will be deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation.

(e) *Examples.* The application of section 305(b)(2) to distributions of stock and section 305(c) to deemed distributions of stock may be illustrated by the following examples:

Example 1. Corporation X is organized with two classes of common stock, class A and class B. Each share of stock is entitled to share equally in the assets and earnings and profits of the corporation. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in cash. Since the class A shareholders as a class will have increased their proportionate interests in the assets and earnings and profits of the corporation and the class B shareholders will have received cash, the additional shares of class A stock are distributions of property to

which section 301 applies. This is true even with respect to those shareholders who may own class A stock and class B stock in the same proportion.

Example 2. Corporation Y is organized with two classes of stock, class A common, and class B, which is nonconvertible and limited and preferred as to dividends. A dividend is declared upon the class A stock payable in additional shares of class A stock and a dividend is declared on the class B stock payable in cash. The distribution of class A stock is not one to which section 301 applies because the distribution does not increase the proportionate interests of the class A shareholders as a class.

Example 3. Corporation K is organized with two classes of stock, class A common, and class B, which is nonconvertible preferred stock. A dividend is declared upon the class A stock payable in shares of class B stock and a dividend is declared on the class B stock payable in cash. Since the class A shareholders as a class have an increased interest in the assets and earnings and profits of the corporation, the stock distribution is treated as a distribution to which section 301 applies. If, however, a dividend were declared upon the class A stock payable in a new class of preferred stock that is subordinated in all respects to the class B stock, the distribution would not increase the proportionate interests of the class A shareholders in the assets or earnings and profits of the corporation and would not be treated as a distribution to which section 301 applies.

Example 4.

(i) Corporation W has one class of stock outstanding, class A common. The corporation also has outstanding interest paying securities convertible into class A common stock which have a fixed conversion ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. Corporation W distributes to the class A shareholders rights to acquire additional shares of class A stock. During the year, interest is paid on the convertible securities.

(ii) The stock rights and convertible securities are considered to be outstanding stock of the corporation and the distribution increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation. Therefore, the distribution is treated as a distribution to which section 301 applies. The same result would follow if, instead of convertible securities, the corporation had outstanding convertible stock. If, however, the conversion ratio of the securities or stock were fully adjusted to reflect the distribution of rights to the class A shareholders, the rights to acquire class A stock would not increase the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation and would not be treated as a distribution to which section 301 applies.

Example 5.

(i) Corporation S is organized with two classes of stock, class A common and class B convertible preferred. The class B is fully protected against dilution in the event of a stock dividend or stock split with respect to the class A stock; however, no adjustment in the conversion ratio is required to be made until the stock dividends equal 3 percent of the common stock issued and outstanding on the date of the first such stock dividend except that such adjustment must be made no later than 3 years after the date of the stock dividend. Cash dividends are paid annually on the class B stock.

(ii) Corporation S pays a 1 percent stock dividend on the class A stock in 1970. In 1971, another 1 percent stock dividend is paid and in 1972 another 1 percent stock dividend is paid. The conversion ratio of the class B stock is increased in 1972 to reflect the three stock dividends paid on the class A stock. The distributions of class A stock are not distributions to which section 301 applies because they do not increase the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation.

Example 6.

(i) Corporation M is organized with two classes of stock outstanding, class A and class B. Each class B share may be converted, at the option of the holder, into class A shares. During the first year, the conversion ratio is one share of class A stock for each share of class B stock. At the beginning of each subsequent year, the conversion ratio is increased by 0.05 share of class A stock for each share of class B stock. Thus, during the second year, the conversion ratio would be 1.05 shares of class A stock for each share of class B stock, during the third year, the ratio would be 1.10 shares, etc.

(ii) M pays an annual cash dividend on the class A stock. At the beginning of the second year, when the conversion ratio is increased to 1.05 shares of class A stock for each share of class B stock, a distribution of 0.05 shares of class A stock is deemed made under section 305(c) with respect to each share of class B stock, since the proportionate interests of the class B shareholders in the assets or earnings and profits of M are increased and the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

Example 7.

(i) Corporation N has two classes of stock outstanding, class A and class B. Each class B share is convertible into class A stock. However, in accordance with a specified formula, the conversion ratio is decreased each time a cash dividend is paid on the class B stock to reflect the amount of the cash dividend. The conversion ratio is also adjusted in the event that cash dividends are paid on the class A stock to increase the number of class A shares into which the class B shares are convertible to compensate the class B shareholders for the cash dividend paid on the class A stock.

(ii) In 1972, a $1 cash dividend per share is declared and paid on the class B stock. On the date of payment, the conversion ratio of the class B stock is decreased. A distribution of stock is deemed made under section 305(c) to the class A shareholders, since the proportionate interest of the class A shareholders in the assets or earnings and profits of the corporation is increased and the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

(iii) In the following year a cash dividend is paid on the class A stock and none is paid on the class B stock. The increase in conversion rights of the class B shares is deemed to be a distribution under section 305(c) to the class B shareholders since their proportionate interest in the assets or earnings and profits of the corporation is increased and since the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

Example 8.

Corporation T has 1,000 shares of stock outstanding. C owns 100 shares. Nine other shareholders each owns 100 shares. Pursuant to a plan for periodic redemptions, T redeems up to 5 percent of each shareholder's stock each year. During the year, each of the nine other shareholders has 5 shares of his stock redeemed for cash. Thus, C's proportionate interest in the assets and earnings and profits of T is increased. Assuming that the cash received by the nine other shareholders is taxable under section 301, C is deemed under section 305(c) to have received a distribution under section 305(b)(2) of 5.25 shares of T stock to which section 301 applies. The amount of C's distribution is measured by the fair market value of the number of shares which would have been distributed to C had the corporation sought to increase his interest by 0.47 percentage points (C owned 10 percent of the T stock immediately before the redemption and 10.47 percent immediately thereafter) and the other shareholders continued to hold 900 shares (i.e.,

(a) $100 \div 955 = 10.47\%$ (percent of C's ownership after redemption)

(b) $100 + x \div 1000 + x = 10.47\%$; $x = 5.25$ (additional shares considered to be distributed to C)).

Since in computing the amount of additional shares deemed to be distributed to C the redemption of shares is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of the corporation which is deemed to be distributed. Thus, in the example, 1,005.25 shares of stock are considered as outstanding after the redemption. The value of each share deemed to be distributed to C is then determined by dividing the 1,005.25 shares into the aggregate fair market value of the actual shares outstanding (955) after the redemption.

Example 9.

(i) Corporation O has a stock redemption program under which, instead of paying out earnings and profits to its shareholders in the form of dividends, it redeems the stock of its shareholders up to a stated amount which is determined by the earnings and profits of the corporation. If the stock tendered for redemption exceeds the stated amount, the corporation redeems the stock on a pro rata basis up to the stated amount.

(ii) During the year corporation O offers to distribute $10,000 in redemption of its stock. At the time of the offering, corporation O has 1,000 shares outstanding of which E and F each owns 150 shares and G and H each owns 350 shares. The corporation redeems 15 shares from E and 35 shares from G. F and H continue to hold all of their stock.

(iii) F and H have increased their proportionate interests in the assets and earnings and profits of the corporation. Assuming that the cash E and G receive is taxable under section 301, F will be deemed under section 305(c) to have received a distribution under section 305(b)(2) of 16.66 shares of stock to which section 301 applies and H will be deemed under section 305(c) to have received a distribution under section 305(b)(2) of 38.86 shares of stock to which section 301 applies. The amount of the distribution to F and H is measured by the number of shares which would have been distributed to F and H had the corporation sought to increase the interest of F by 0.79 percentage points (F owned 15 percent of the stock immediately before the redemption and 15.79 percent immediately thereafter) and the interest of H by 1.84 percentage points (H owned 35 percent of the stock immediately before the redemption and 36.84 percent immediately thereafter) and E and G had continued to hold 150 shares and 350 shares, respectively (i.e.,

(a) $150 \div 950 + 350 \div 950 = 52.63\%$ (percent of F and H's ownership after redemption)

(b) $500 + y \div 1000 + y = 52.63\%$; $y = 55.52$ (additional shares considered to be distributed to F and H)

(c)(1) $150 \div 500 \times 55.52 = 16.66$ (shares considered to be distributed to F)

(2) $350 \div 500 \times 55.52 = 38.86$ (shares considered to be distributed to H)).

Since in computing the amount of additional shares deemed to be distributed to F and H the redemption of shares is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of the corporation which is deemed to be distributed. Thus, in the example, 1,055.52 shares of stock are considered as outstanding after the redemption. The value of each share deemed to be distributed to F and H is then determined by dividing the 1,055.52 shares into the aggregate fair market value of the actual shares outstanding (950) after the redemption.

Example 10. Corporation P has 1,000 shares of stock outstanding. T owns 700 shares of the P stock and G owns 300 shares of the P stock. In a single and isolated redemption to which section 301 applies, the corporation redeems 150 shares of T's stock. Since this is an isolated redemption and is not a part of a periodic redemption plan, G is not treated as having received a deemed distribution under section 305(c) to which sections 305(b)(2) and 301 apply even though he has an increased proportionate interest in the assets and earnings and profits of the corporation.

Example 11. Corporation Q is a large corporation whose sole class of stock is widely held. However, the four largest shareholders are officers of the corporation and each owns 8 percent of the outstanding stock. In 1974, in a distribution to which section 301 applies, the corporation redeems 1.5 percent of the stock from each of the four largest shareholders in preparation for their retirement. From 1970 through 1974, the corporation distributes annual stock dividends to its shareholders. No other distributions were made to these shareholders. Since the 1974 redemptions are isolated and are not part of a plan for periodically redeeming the stock of the corporation, the shareholders receiving stock dividends will not be treated as having received a distribution under section 305(b)(2) even though they have an increased proportionate interest in the assets and earnings and profits of the corporation and whether or not the redemptions are treated as distributions to which section 301 applies.

Example 12. Corporation R has 2,000 shares of class A stock outstanding. Five shareholders own 300 shares each and five shareholders own 100 shares each. In preparation for the retirement of the five major shareholders, corporation R, in a single and isolated transaction, has a recapitalization in which each share of class A stock may be exchanged either for five shares of new class B nonconvertible preferred stock plus 0.4 share of new class C common stock, or for two shares of new class C common stock. As a result of the exchanges, each of the five major shareholders receives 1,500 shares of class B nonconvertible preferred stock and 120 shares of class C common stock. The remaining shareholders each receives 200 shares of class C common stock. None of the exchanges are within the purview of section 305.

Example 13. Corporation P is a widely-held company whose shares are listed for trading on a stock exchange. P distributes annual cash dividends to its shareholders. P purchases shares of its common stock directly from small stockholders (holders of record of 100 shares or less) or through brokers where the holders may not be known at the time of purchase. Where such purchases are made through brokers, they are pursuant to the rules and regulations of the Securities and Exchange Commission. The shares are purchased for the purpose of issuance to employee stock investment plans, to holders of convertible stock or debt, to holders of stock options, or for future acquisitions. Provided the purchases are not pursuant to a plan to increase the proportionate interest of some shareholders and distribute property to other shareholders, the remaining shareholders of P are not treated as having received a deemed distribution under section 305(c) to which section 305(b)(2) and 301 apply, even though they have an increased proportionate interest in the assets and earnings and profits of the corporation.

Example 14. Corporation U is a large manufacturing company whose products are sold through independent dealers. In order to assist individuals who lack capital to become dealers, the corporation has an established investment plan under which it provides 75 percent of the capital necessary to form a dealership corporation and the individual dealer provides the remaining 25 percent. Corporation U receives class A stock and a note representing its 75 percent interest. The individual dealer receives class B stock representing his 25 percent interest. The class B stock is nonvoting until all the class A shares are redeemed. At least 70 percent of the earnings and profits of the dealership corporation must be used each year to retire the note and to redeem the class A stock. The class A stock is redeemed at a fixed price. The individual dealer has no control over the redemption of stock and has no right to have his stock redeemed during the period the plan is in existence. U's investment is thus systematically eliminated and the individual becomes the sole owner of the dealership corporation. Since this type of plan is akin to a security arrangement, the redemptions of the class A stock will not be deemed under section 305(c) as distributions taxable under sections 305(b)(2) and 301 during the years in which the class A stock is redeemed.

§1.305-4 Distributions of common and preferred stock.

(a) *In general.* Under section 305(b)(3), a distribution (or a series of distributions) by a corporation which results in the receipt of preferred stock whether or not convertible into common stock) by some common shareholders and the receipt of common stock by other common shareholders is treated as a distribution of property to which

section 301 applies. For the meaning of the term *a series of distribution,* see subparagraphs (1) through (6) of § 1.305-3(b).

(b) *Examples.* The application of section 305(b)(3) may be illustrated by the following examples:

Example 1. Corporation X is organized with two classes of common stock, class A and class B. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in newly authorized class C stock which is nonconvertible and limited and preferred as to dividends. Both the distribution of class A shares and the distribution of new class C shares are distributions to which section 301 applies.

Example 2. Corporation Y is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized class B preferred stock which is convertible into class A stock no later than 6 months from the date of distribution at a price that is only slightly higher than the market price of class A stock on the date of distribution. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period of time some shareholders will exercise their conversion rights and some will not. Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which section 301 applies.

§1.305-5 Distributions on preferred stock.

(a) *In general.* Under section 305(b)(4), a distribution by a corporation of its stock (or rights to acquire its stock) made (or deemed made under section 305(c)) with respect to its preferred stock is treated as a distribution of property to which section 301 applies unless the distribution is made with respect to convertible preferred stock to take into account a stock dividend, stock split, or any similar event (such as the sale of stock at less than the fair market value pursuant to a rights offering) which would otherwise result in the dilution of the conversion right. For purposes of the preceding sentence, an adjustment in the conversion ratio of convertible preferred stock made solely to take into account the distribution by a closed end regulated investment company of a capital gain dividend with respect to the stock into which such stock is convertible shall not be considered a "similar event." The term *preferred stock* generally refers to stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of *preferred stock* for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited, and that such stock does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest. Among the facts and circumstances to be considered are the prior and anticipated earnings per share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. The determination of whether stock is preferred for purposes of section 305 shall be made without regard to any right to convert such stock into another class of stock of the corporation. The term *preferred stock,* however, does not include convertible debentures.

§1.306-1 General.

(a) Section 306 provides, in general, that the proceeds from the sale or redemption of certain stock (referred to as "section 306 stock") shall be treated either as ordinary income or as a distribution of property to which section 301 applies. Section 306 stock is defined in section 306(c) and is usually preferred stock received either as a nontaxable dividend or in a transaction in which no gain or loss is recognized. Section 306(b) lists certain circumstances in which the special rules of section 306(a) shall not apply.

(b)

(1) If a shareholder sells or otherwise disposes of section 306 stock (other than by redemption or within the exceptions listed in section 306(b)), the entire proceeds received from such disposition shall be treated as ordinary income to the extent that the fair market value of the stock sold, on the date distributed to the shareholder, would have been a dividend to such shareholder had the distributing corporation distributed cash in lieu of stock. Any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock disposed of, shall be treated as gain from the sale of a capital asset or noncapital asset as the case may be. No loss shall be recognized. No reduction of earnings and profits results from any disposition of stock other than a redemption. The term *disposition* under section 306(a)(1) includes, among other things, pledges of stock under certain circumstances, particularly where the pledgee can look only to the stock itself as its security.

(2) Section 306(a)(1) may be illustrated by the following examples:

Example 1. On December 15, 1954, A and B owned equally all of the stock of Corporation X which files its income tax return on a calendar year basis. On that date Corporation X distributed pro rata 100 shares of preferred stock as a dividend on its outstanding common stock. On December 15, 1954, the preferred stock had a fair market value of $10,000. On December 31, 1954, the earnings and profits of Corporation X were $20,000. The 50 shares of preferred stock so distributed to A had an allocated basis to him of $10 per share or a total of $500 for the 50 shares. Such shares had a fair market value of $5,000 when issued. A sold the 50 shares of preferred stock on July 1, 1955, for $6,000. Of this amount $5,000 will be treated as ordinary income; $500 ($6,000 minus $5,500) will be treated as gain from the sale of a capital or noncapital asset as the case may be.

Example 2. The facts are the same as in *Example 1* except that A sold his 50 shares of preferred stock for $5,100. Of this amount $5,000 will be treated as ordinary income. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $400, the allocated basis of $500 reduced by the $100 received.

Example 3. The facts are the same as in *Example 1* except that A sold 25 of his shares of preferred stock for $2,600. Of this amount $2,500 will be treated as ordinary income. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $150, the allocated basis of $250 reduced by the $100 received.

(c) The entire amount received by a shareholder from the redemption of section 306 stock shall be treated as a distribution of property under section 301. See also section 303 (relating to distribution in redemption of stock to pay death taxes).

§1.306-2 Exception.

(a) If a shareholder terminates his entire stock interest in a corporation—

(1) By a sale or other disposition within the requirements of section 306(b)(1)(A), or

(2) By redemption under section 302(b)(3) (through the application of section 306(b)(1)(B)),

the amount received from such disposition shall be treated as an amount received in part or full payment for the stock sold or redeemed. In the case of a sale, only the stock interest need be terminated. In determining whether an entire stock interest has been terminated under section 306(b)(1)(A), all of the provisions of section 318(a) (relating to constructive ownership of stock) shall be applicable. In determining whether a shareholder has terminated his entire interest in a corporation by a redemption of his stock under section 302(b)(3), all of the provisions of section 318(a) shall be applicable unless the shareholder meets the requirements of section 302(c)(2) (relating to termination of all interest in the corporation). If the requirements of section 302(c)(2) are met, section 318(a)(1) (relating to members of a family) shall be inapplicable. Under all circumstances paragraphs (2), (3), (4), and (5) of section 318(a) shall be applicable.

(b) Section 306(a) does not apply to—

(1) Redemptions of section 306 stock pursuant to a partial or complete liquidation of a corporation to which part II (section 331 and following), subchapter C, chapter 1 of the Code applies,

(2) Exchanges of section 306 stock solely for stock in connection with a reorganization or in an exchange under section 351, 355, or section 1036 (relating to exchanges of stock for stock in the same corporation) to the extent that gain or loss is not recognized to the shareholder as the result of the exchange of the stock (see paragraph (d) of §1.306-3 relative to the receipt of other property), and

(3) A disposition or redemption, if it is established to the satisfaction of the Commissioner that the distribution, and the disposition or redemption, was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. However, in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, it is not necessary to establish that the distribution was not in pursuance of such a plan. For example, in the absence of such a plan and of any other facts the first sentence of this subparagraph would be applicable to the case of dividends and isolated dispositions of section 306 stock by minority shareholders. Similarly, in the absence of such a plan and of any other facts, if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a disposition one of the principal purposes of which is the avoidance of Federal income tax.

§1.306-3 Section 306 stock defined.

(a) For the purpose of subchapter C, chapter 1 of the code, the term *section 306 stock* means stock which meets the requirements of section 306(c)(1). Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, if a distribution of money by the distributing corporation in lieu of such stock would have been a dividend in whole or in part. However, except as provided in section 306(g), if no part of a distribution of money by the distributing corporation in lieu of such stock would have been a dividend, the stock distributed will not constitute section 306 stock.

(b) For the purpose of section 306, rights to acquire stock shall be treated as stock. Such rights shall not be section 306 stock if no part of the distribution would have been a dividend if money had been distributed in lieu

of the rights. When stock is acquired by the exercise of rights which are treated at section 306 stock, the stock acquired is section 306 stock. Upon the disposition of such stock (other than by redemption or within the exceptions listed in section 306(b)), the proceeds received from the disposition shall be treated as ordinary income to the extent that the fair market value of the stock rights, on the date distributed to the shareholder, would have been a dividend to the shareholder had the distributing corporation distributed cash in lieu of stock rights. Any excess of the amount realized over the sum of the amount treated as ordinary income plus the adjusted basis of the stock, shall be treated as gain from the sale of the stock.

(c) Section 306(c)(1)(A) provides that section 306 stock is any stock (other than common issued with respect to common) distributed to the shareholder selling or otherwise disposing thereof if, under section 305(a) (relating to distributions of stock and stock rights) any part of the distribution was not included in the gross income of the distributee.

(e) Section 306(c)(1)(C) includes in the definition of section 306 stock any stock (except as provided in section 306(c)(1)(B)) the basis of which in the hands of the person disposing of such stock, is determined by reference to section 306 stock held by such shareholder or any other person. Under this paragraph common stock can be section 306 stock. Thus, if a person owning section 306 stock in Corporation A transfers it to Corporation B which is controlled by him in exchange for common stock of Corporation B in a transaction to which section 351 is applicable, the common stock so received by him would be section 306 stock and subject to the provisions of section 306(a) on its disposition. In addition, the section 306 stock transferred is section 306 stock in the hands of Corporation B, the transferee. Section 306 stock transferred by gift remains section 306 stock in the hands of the donee. Stock received in exchange for section 306 stock under section 1036(a) (relating to exchange of stock for stock in the same corporation) or under so much of section 1031(b) as relates to section 1036(a) becomes section 306 stock and acquires, for purposes of section 306, the characteristics of the section 306 stock exchanged. The entire amount of the fair market value of the other property received in such transaction shall be considered as received upon a disposition (other than a redemption) to which section 306(a) applies. Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death under section 1014 or the optional valuation date under section 2032. Section 306 stock continues to be so classified if the basis of such stock is determined under section 1022.

§1.307-1 General.

(a) If a shareholder receives stock or stock rights as a distribution on stock previously held and under section 305 such distribution is not includible in gross income then, except as provided in section 307(b) and § 1.307-2, the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and pursuant to section 305 part of the distribution is not includible in gross income, then (except as provided in section 307(b) and § 1.307-2) the basis of the stock with respect to which the distribution is made shall be allocated between

(1) the old stock and

(2) that part of the new stock or rights which is not includible in gross income, in proportion to the fair market values of each on the date of distribution. The date of distribution in each case shall be the date the stock or the rights are distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.

§1.312-1 Adjustment to earnings and profits reflecting distributions by corporations.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305(b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§1.312-3 Liabilities.

The amount of any reductions in earnings and profits described in section 312 (a) or (b) shall be (a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and (b) increased by the amount of gain recognized to the corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

§1.312-6 Earnings and profits.

(a) In determining the amount of earnings and profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated before March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income (or net income, as the case may be). For instance, a corporation keeping its books and filing its income tax returns under subchapter E, chapter 1 of the Code, on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 453 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 831 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 832(b)(4) and which is segregated accordingly in the unearned premium reserve.

(b) Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts. Gains and losses within the purview of section 1002 or corresponding provisions of prior revenue acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

§1.312-7 Effect on earnings and profits of gain or loss realized after February 28, 1913.

(b)

(1) The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing taxable income (or net income, as the case may be) under the law applicable to the year in which such sale or disposition was made. As used in this paragraph, the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized. For example, see section 356. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section

1091 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 267 and 1211 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 1091 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The *recognized* gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 312(f)(1) as distinguished from the realized gain or loss used in computing taxable income (or net income, as the case may be).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Corporation X on January 1, 1952, owned stock in Corporation Y which it had acquired from Corporation Y in December 1951, in an exchange transaction in which no gain or loss was recognized. The adjusted basis to Corporation X of the property exchanged by it for the stock in Corporation Y was $30,000. The fair market value of the stock in Corporation Y when received by Corporation X was $930,000. On April 9, 1955, Corporation X made a cash distribution of $900,000 and, except for the possible effect of the transaction in 1951, had no earnings or profits accumulated after February 28, 1913, and had no earnings or profits for the taxable year. The amount of $900,000 representing the excess of the fair market value of the stock of Corporation Y over the adjusted basis of the property exchanged therefor was not recognized gain to Corporation X under the provisions of section 112 of the Internal Revenue Code of 1939. Accordingly, the earnings and profits of Corporation X are not increased by $900,000, the amount of the gain realized but not recognized in the exchange, and the distribution was not a taxable dividend. The basis in the hands of Corporation Y of the property acquired by it from Corporation X is $30,000. If such property is thereafter sold by Corporation Y, gain or loss will be computed on such basis of $30,000, and earnings and profits will be increased or decreased accordingly.

Example 2. On January 2, 1910, Corporation M acquired nondepreciable property at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of Corporation M was $2,200. On December 31, 1952, Corporation M transfers such property to Corporation N in exchange for $1,900 in cash and all Corporation N's stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of Corporation M, the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March 1, 1913, value), $1,900 of which is recognized under section 356, since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by only $800 as a reputing the earnings and profits of Corporation M for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112(c) of the Internal Revenue Code of 1939, the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after March 1, 1913, see § 1.312-9.

Example 3.

On July 31, 1955, Corporation R owned oil-producing property acquired after February 28, 1913, at a cost of $200,000, but having an adjusted basis (by reason of taking percentage depletion) of $100,000 for determining gain. However, the adjusted basis of such property to be used in computing gain or loss for the purpose of earnings and profits is, because of the provisions of the third sentence of section 312(f)(1), $150,000. On such day Corporation R transferred such property to Corporation S in exchange for $25,000 in cash and all of the stock

of Corporation S, which had a fair market value of $100,000. For the purpose of computing taxable income, Corporation R has realized a gain of $25,000 as a result of this transaction, all of which is recognized under section 356. For the purpose of computing earnings and profits, however, Corporation R has realized a loss of $25,000, none of which is recognized owing to the provisions of section 356(c). The earnings and profits of Corporation R are therefore neither increased nor decreased as a result of the transaction. The adjusted basis of the Corporation S stock in the hands of Corporation R for purposes of computing earnings and profits, however, will be $125,000 (though only $100,000 for the purpose of computing taxable income), computed as follows:

Basis of property transferred	$200,000
Less money received on exchange	25,000
Plus gain or minus loss recognized on exchange	None
Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred)	50,000
Adjusted basis of stock	125,000

If, therefore, Corporation R should subsequently sell the Corporation S stock for $100,000, a loss of $25,000 will again be realized for the purpose of computing earnings and profits, all of which will be recognized and will be applied to decrease the earnings and profits of Corporation R.

§1.316-1 Dividends.

(a)

(1) The term *dividend* for the purpose of subtitle A of the Code (except when used in subchapter L, chapter 1 of the Code, in any case where the reference is to dividends and similar distributions of insurance companies paid to policyholders as such) comprises any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(i) Earnings and profits accumulated since February 28, 1913, or

(ii) Earnings and profits of the taxable year computed without regard to the amount of the earnings and profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings and profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

(2) Where a corporation distributes property to its shareholders on or after June 22, 1954, the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation.

(3) The rule of (2) above may be illustrated by the following example:

Example. X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of $10,000. Corporation A distributes property having a basis of $6,000 and a fair market value of $16,000 to its shareholders, each shareholder receiving property with a basis of $3,000 and with a fair market value of $8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is $5,000.

(e) The application of section 316 may be illustrated by the following examples:

§1.316-2 Sources of distribution in general.

(a) For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. In determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year; third, to the earnings and profits accumulated before March 1, 1913, only after all the earnings and profits of the taxable year and all the earnings and profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings and profits only after the earnings and profits have been distributed.

(b) If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. See § 1.316-1. If the distributions made during the taxable year exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year. The portion of each such distribution which is not regarded as out of earnings and profits of the taxable year shall be considered a taxable dividend to the extent of the earnings and profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

(c) The provisions of the section may be illustrated by the following example:

Example.

At the beginning of the calendar year 1955, Corporation M had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1955 amounted to $30,000. During the year it made quarterly cash distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and before the taxable year, as follows:

Distributions during 1955		Portion out of earnings and profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and before the taxable year	Taxable amt. of each distribution
Date	**Amount**			
March 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
September 10	15,000	7,500		7,500
December 10	15,000	7,500		7,500
Total amount taxable as dividends				42,000

§1.318-1 Constructive ownership of stock; introduction.

(a) For the purposes of certain provisions of chapter 1 of the Code, section 318(a) provides that stock owned by a taxpayer includes stock constructively owned by such taxpayer under the rules set forth in such section. An individual is considered to own the stock owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and by or for his children, grandchildren, and parents. Under section 318(a)(2) and (3), constructive ownership rules are established for partnerships and partners, estates and beneficiaries, trusts and beneficiaries, and corporations and stockholders. If any person has an option to acquire stock, such stock is considered as owned by such person. The term *option* includes an option to acquire such an option and each of a series of such options.

(b) In applying section 318(a) to determine the stock ownership of any person for any one purpose—

(1) A corporation shall not be considered to own its own stock by reason of section 318(a)(3)(C);

(2) In any case in which an amount of stock owned by any person may be included in the computation more than one time, such stock shall be included only once, in the manner in which it will impute to the person concerned the largest total stock ownership; and

(3) In determining the 50-percent requirement of section 318(a)(2)(C) and (3)(C), all of the stock owned actually and constructively by the person concerned shall be aggregated.

§1.318-2 Application of general rules.

(a) The application of paragraph (b) of §1.318-1 may be illustrated by the following examples:

Example 1. H, an individual, owns all of the stock of corporation A. Corporation A is not considered to own the stock owned by H in corporation A.

Example 2. H, an individual, his wife, W, and his son, S, each own one-third of the stock of the Green Corporation. For purposes of determining the amount of stock owned by H, W, or S for purposes of section 318(a)(2)(C) and (3)(C), the amount of stock held by the other members of the family shall be added pursuant to paragraph (b)(3) of §1.318-1 in applying the 50-percent requirement of such section. H, W, or S, as the case

may be, is for this purpose deemed to own 100 percent of the stock of the Green Corporation.

(b) The application of section 318(a)(1), relating to members of a family, may be illustrated by the following example:

Example. An individual, H, his wife, W, his son, S, and his grandson (S's son), G, own the 100 outstanding shares of stock of a corporation, each owning 25 shares. H, W, and S are each considered as owning 100 shares. G is considered as owning only 50 shares, that is, his own and his father's.

(c) The application of section 318(a)(2) and (3), relating to partnerships, trusts and corporations, may be illustrated by the following examples:

Example 1. A, an individual, has a 50 percent interest in a partnership. The partnership owns 50 of the 100 outstanding shares of stock of a corporation, the remaining 50 shares being owned by A. The partnership is considered as owning 100 shares. A is considered as owning 75 shares.

Example 2. A testamentary trust owns 25 of the outstanding 100 shares of stock of a corporation. A, an individual, who holds a vested remainder in the trust having a value, computed actuarially equal to 4 percent of the value of the trust property, owns the remaining 75 shares. Since the interest of A in the trust is a vested interest rather than a contingent interest (whether or not remote), the trust is considered as owning 100 shares. A is considered as owning 76 shares.

Example 3. The facts are the same as in (2), above, except that A's interest in the trust is a contingent remainder. A is considered as owning 76 shares. However, since A's interest in the trust is a remote contingent interest, the trust is not considered as owning any of the shares owned by A.

Example 4. A and B, unrelated individuals, own 70 percent and 30 percent, respectively, in value of the stock of Corporation M. Corporation M owns 50 of the 100 outstanding shares of stock of Corporation O, the remaining 50 shares being owned by A. Corporation M is considered as owning 100 shares of Corporation O, and A is considered as owning 85 shares.

Example 5. A and B, unrelated individuals, own 70 percent and 30 percent, respectively, of the stock of corporation M. A, B, and corporation M all own stock of corporation O. Since B owns less than 50 percent in value of the stock of corporation M, neither B nor corporation M constructively owns the stock of corporation O owned by the other. However, for purposes of certain sections of the Code, such as sections 304 and 856(d), the 50-percent limitation of section 318(a)(2)(C) and (3)(C) is disregarded or is reduced to less than 30 percent. For such purposes, B constructively owns his proportionate share of the stock of corporation O owned directly by corporation M, and corporation M constructively owns the stock of corporation O owned by B.

§1.318-3 Estates, trusts, and options.

(c) The application of section 318(a) relating to options may be illustrated by the following example:

§1.318-4 Constructive ownership as actual ownership; exceptions.

(a) *In general.* Section 318(a)(5)(A) provides that, except as provided in section 318(a)(5) (B) and (C), stock constructively owned by a person by reason of the application of section 318(a) (1), (2), (3), or (4) shall be considered as actually owned by such person for purposes of applying section 318(a) (1), (2), (3), and (4). For example, if a trust owns 50 percent of the stock of corporation X, stock of corporation Y owned by corporation X

which is attributed to the trust may be further attributed to the beneficiaries of the trust.

(b) *Constructive family ownership.* Section 318(a)(5)(B) provides that stock constructively owned by an individual by reason of ownership by a member of his family shall not be considered as owned by him for purposes of making another family member the constructive owner of such stock under section 318(a)(1). For example, if F and his two sons, A and B, each own one-third of the stock of a corporation, under section 318(a)(1), A is treated as owning constructively the stock owned by his father but is not treated as owning the stock owned by B. Section 318(a)(5)(B) prevents the attribution of the stock of one brother through the father to the other brother, an attribution beyond the scope of section 318(a)(1) directly.

(c) *Reattribution.*

(1) Section 318(a)(5)(C) provides that stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of section 318(a)(3) shall not be considered as owned by it for purposes of applying section 318(a)(2) in order to make another the constructive owner of such stock. For example, if two unrelated individuals are beneficiaries of the same trust, stock held by one which is attributed to the trust under section 318(a)(3) is not reattributed from the trust to the other beneficiary. However, stock constructively owned by reason of section 318(a)(2) may be reattributed under section 318(a)(3). Thus, for example, if all the stock of corporations X and Y is owned by A, stock of corporation Z held by X is attributed to Y through A.

(2) Section 318(a)(5)(C) does not prevent reattribution under section 318(a)(2) of stock constructively owned by an entity under section 318(a)(3) if the stock is also constructively owned by the entity under section 318(a)(4). For example, if individuals A and B are beneficiaries of a trust and the trust has an option to buy stock from A, B is considered under section 318(a)(2)(B) as owning a proportionate part of such stock.

(3) Section 318(a)(5)(C) is effective on and after August 31, 1964, except that for purposes of sections 302 and 304 it does not apply with respect to distributions in payment for stock acquisitions or redemptions if such acquisitions or redemptions occurred before August 31, 1964.

§1.331-1 Corporate liquidations.

(a) *In general.* Section 331 contains rules governing the extent to which gain or loss is recognized to a shareholder receiving a distribution in complete or partial liquidation of a corporation. Under section 331(a)(1), it is provided that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Under section 331(a)(2), it is provided that amounts distributed in partial liquidation of a corporation shall be treated as in full or part payment in exchange for the stock. For this purpose, the term *partial liquidation* shall have the meaning ascribed in section 346. If section 331 is applicable to the distribution of property by a corporation, section 301 (relating to the effects on a shareholder of distributions of property) has no application other than to a distribution in complete liquidation to which section 316(b)(2)(B) applies. See paragraph (b)(2) of § 1.316-1.

(b) *Gain or loss.* The gain or loss to a shareholder from a distribution in partial or complete liquidation is to be determined under section 1001 by comparing the amount of the distribution with the cost or other basis of the stock. The gain or loss will be recognized to the extent provided in section 1002 and will be subject to the provisions of parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code.

(e) *Example.* The provisions of this section may be illustrated by the following example:

Example. A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1951 at a cost of

$1,500 and the remainder of 10 shares in December 1954 at a cost of $2,900. He receives in April 1955 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1951, and $2,500 on the 10 shares acquired in December 1954. The gain of $1,000 on the shares acquired in 1951 is a long-term capital gain to be treated as provided in parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code. The loss of $400 on the shares acquired in 1954 is a short-term capital loss to be treated as provided in parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code.

§1.332-1 Distributions in liquidation of subsidiary corporation; general.

Under the general rule prescribed by section 331 for the treatment of distributions in liquidation of a corporation, amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation, and gain or loss from the receipt of such amounts is to be determined as provided in section 1001. Section 332 excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distribution in complete liquidation of the stock of another corporation and provides for the nonrecognition of gain or loss in those cases which meet the statutory requirements. Section 367 places a limitation on the application of section 332 in the case of foreign corporations. See section 334(b) for the basis for determining gain or loss from the subsequent sale of property received upon complete liquidations such as described in this section. See section 453(d)(4)(A) relative to distribution of installment obligations by subsidiary.

§1.332-2 Requirements for nonrecognition of gain or loss.

(a) The nonrecognition of gain or loss under section 332 is limited to the receipt of property by a corporation that is the actual owner of stock (in the liquidating corporation) meeting the requirements of section 1504(a)(2). The recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

(b) Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.

(c) To constitute a distribution in complete liquidation within the meaning of section 332, the distribution must be

(1) made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or

(2) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed. Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction. (See 26 CFR (1939) 39.22(a)-20 (Regulations 118).)

(d) If a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code of 1954 and satisfies the requirements of section 332, it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Code and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 332, even though for purposes of those provisions relating to corporate reorganizations the amount received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or securities in a tax-free exchange as described in section 361 and the cancellation or redemption of the stock not owned by the recipient corporation is treated as occurring as a result of a taxfree exchange described in section 354.

(e) The application of these rules may be illustrated by the following example:

Example. On September 1, 1954, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and had no voting rights. On that date, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of common stock of the M Corporation. By statutory merger consummated on October 1, 1954, pursuant to a plan of liquidation adopted on September 1, 1954, the M Corporation was merged into the O Corporation, the O Corporation under the plan issuing stock which was received by the other holders of the stock of the M Corporation. The receipt by the O Corporation of the properties of the M Corporation is a distribution received by the O Corporation in complete liquidation of the M Corporation within the meaning of section 332, and no gain or loss is recognized as the result of the receipt of such properties.

(f) *Applicability date.* The first sentence of paragraph (a) of this section applies to plans of complete liquidation adopted after March 28, 1985, except as specified in section 1804(e)(6)(B)(ii) and (iii) of Public Law 99-514.

§1.332-2 Requirements for nonrecognition of gain or loss.

(a) The nonrecognition of gain or loss under section 332 is limited to the receipt of property by a corporation that is the actual owner of stock (in the liquidating corporation) meeting the requirements of section 1504(a)(2). The recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

(b) Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.

(c) To constitute a distribution in complete liquidation within the meaning of section 332, the distribution must be

(1) made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or

(2) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed. Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction. (See 26 CFR (1939) 39.22(a)-20 (Regulations 118).)

(d) If a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code of 1954 and satisfies the requirements of section 332, it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Code and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 332, even though for purposes of those provisions relating to corporate reorganizations the amount received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or securities in a tax-free exchange as described in section 361 and the cancellation or redemption of the stock not owned by the recipient corporation is treated as occurring as a result of a taxfree exchange described in section 354.

(e) The application of these rules may be illustrated by the following example:

Example. On September 1, 1954, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and had no voting rights. On that date, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of common stock of the M Corporation. By statutory merger consummated on October 1, 1954, pursuant to a plan of liquidation adopted on September 1, 1954, the M Corporation was merged into the O Corporation, the O Corporation under the plan issuing stock which was received by the other holders of the stock of the M Corporation. The receipt by the O Corporation of the properties of the M Corporation is a distribution received by the O Corporation in complete liquidation of the M Corporation within the meaning of section 332, and no gain or loss is recognized as the result of the receipt of such properties.

(f) *Applicability date.* The first sentence of paragraph (a) of this section applies to plans of complete liquidation adopted after March 28, 1985, except as specified in section 1804(e)(6)(B)(ii) and (iii) of Public Law 99-514.

§1.332-5 Distributions in liquidation as affecting minority interests.

Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders shall be determined without regard to section 332, since it does not apply to that part of distributions in liquidation received by minority shareholders.

§1.332-7 Indebtedness of subsidiary to parent.

If section 332(a) is applicable to the receipt of the subsidiary's property in complete liquidation, then no gain or loss shall be recognized to the subsidiary upon the transfer of such properties even though some of the properties are transferred in satisfaction of the subsidiary's indebtedness to its parent. See section 337(b)(1). However, any gain or loss realized by the parent corporation on such satisfaction of indebtedness, shall be recognized to the parent corporation at the time of the liquidation. For example, if the parent corporation purchased its subsidiary's bonds at a discount and upon liquidation of the subsidiary the parent corporation receives payment for the face amount of such bonds, gain shall be recognized to the parent corporation. Such gain shall be measured by the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds.

§1.336-2 Availability, mechanics, and consequences of section 336(e) election.

(k) *Examples.* The following examples illustrate the provisions of this section.

§1.338-1 General principles; status of old target and new target.

(a) *In general —*

(1) *Deemed transaction.* Elections are available under section 338 when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. One type of election, under section 338(g), is available to the purchasing corporation. Another type of election, under section 338(h)(10), is, in more limited circumstances, available jointly to the purchasing corporation and the sellers of the stock. (Rules concerning eligibility for these elections are contained in §§ 1.338-2, 1.338-3, and 1.338(h)(10)-1.) However, if, as a result of the deemed purchase of old target's assets pursuant to a section 336(e) election, there would be both a qualified stock purchase and a qualified stock disposition (as defined in § 1.336-1(b)(6)) of the stock of a subsidiary of target, neither a section 338(g) election nor a section 338(h)(10) election may be made with respect to the qualified stock purchase of the subsidiary. Instead, a section 336(e) election may be made with respect to such purchase. See § 1.336-1(b)(6)(ii). Although target is a single corporation under corporate law, if a section 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of subtitle A of the Internal Revenue Code. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities (see § 1.1001-2(a)), and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of those liabilities. (Such transaction is, without regard to its characterization for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale tax consequences.) If a section 338(h)(10) election is made, old target is deemed to liquidate following the deemed asset sale.

(2) *Application of other rules of law.* Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and the regulations thereunder except to the extent otherwise provided in those regulations. See also § 1.338-6(c)(2). Other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets; however, the transaction between old and new target must be a taxable transaction. For example, if the target is an insurance company for which a section 338 election is made, the deemed asset sale results in an assumption reinsurance transaction for the insurance contracts deemed transferred from old target to new target. See, generally, § 1.817-4(d), and for special rules regarding the acquisition of insurance company targets, § 1.338-11. See also § 1.367(a)-8(k)(13) for a rule applicable to gain recognition agreements (filed under §§ 1.367(a)-3(b)(1)(ii) and 1.367(a)-8) and deemed asset sales as a result of an election under section 338(g).

(3) *Overview.* Definitions and special nomenclature and rules for making the section 338 election are provided in § 1.338-2. Qualification for the section 338 election is addressed in § 1.338-3. The amount for which old

target is treated as selling all of its assets (the aggregate deemed sale price, or ADSP) is addressed in § 1.338-4. The amount for which new target is deemed to have purchased all its assets (the adjusted grossed-up basis, or AGUB) is addressed in § 1.338-5. Section 1.338-6 addresses allocation both of ADSP among the assets old target is deemed to have sold and of AGUB among the assets new target is deemed to have purchased. Section 1.338-7 addresses allocation of ADSP or AGUB when those amounts subsequently change. Asset and stock consistency are addressed in § 1.338-8. International aspects of section 338 are covered in § 1.338-9. Rules for the filing of returns are provided in § 1.338-10. Section 1.338-11 provides special rules for insurance company targets. Eligibility for and treatment of section 338(h)(10) elections is addressed in § 1.338(h)(10)-1.

(b) *Treatment of target under other provisions of the Internal Revenue Code —*

(1) *General rule for subtitle A.* Except as provided in this section, new target is treated as a new corporation that is unrelated to old target for purposes of subtitle A of the Internal Revenue Code. Thus—

(i) New target is not considered related to old target for purposes of section 168 and may make new elections under section 168 without taking into account the elections made by old target; and

(ii) New target may adopt, without obtaining prior approval from the Commissioner, any taxable year that meets the requirements of section 441 and any method of accounting that meets the requirements of section 446. Notwithstanding § 1.441-1T(b)(2), a new target may adopt a taxable year on or before the last day for making the election under section 338 by filing its first return for the desired taxable year on or before that date.

(2) *Exceptions for subtitle A.* New target and old target are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare benefit funds (sections 419, 419A, 512(a)(3), and 4976), voluntary employees' beneficiary associations (section 501(c)(9) and the regulations thereunder), and tax on excess tax-exempt organization executive compensation (section 4960) and the regulations in part 53 under section 4960;

(ii) Sections 1311 through 1314 (relating to the mitigation of the effect of limitations), if a section 338(h)(10) election is not made for target;

(iii) Section 108(e)(5) (relating to the reduction of purchase money debt);

(iv) Section 45A (relating to the Indian Employment Credit), section 51 (relating to the Work Opportunity Credit), section 51A (relating to the Welfare to Work Credit), and section 1396 (relating to the Empowerment Zone Act);

(v) Sections 401(h) and 420 (relating to medical benefits for retirees);

(vi) Section 414 (relating to definitions and special rules); and

(vii) Section 846(e) (relating to an election to use an insurance company's historical loss payment pattern).

(viii) Any other provision designated in the Internal Revenue Bulletin by the Internal Revenue Service. See § 601.601(d)(2)(ii) of this chapter. See, for example, § 1.1001-3(e)(4)(i)(F) providing that an election

under section 338 does not result in the substitution of a new obligor on target's debt. See also, for example, § 1.1502-77(c)(8), providing that an election under section 338 does not result in a deemed termination of target's existence for purposes of the rules applicable to the agent for a consolidated group.

(3) *General rule for other provisions of the Internal Revenue Code.* Except as provided in the regulations under section 338 or in the Internal Revenue Bulletin by the Internal Revenue Service (see § 601.601(d)(2)(ii) of this chapter), new target is treated as a continuation of old target for purposes other than subtitle A of the Internal Revenue Code. For example—

(i) New target is liable for old target's Federal income tax liabilities, including the tax liability for the deemed sale tax consequences and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see § 1.1502-6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number.

§1.338-2 Nomenclature and definitions; mechanics of the section 338 election.

(b) *Nomenclature.* For purposes of the regulations under section 338 (except as otherwise provided):

(1) T is a domestic target corporation that has only one class of stock outstanding. Old T refers to T for periods ending on or before the close of T's acquisition date; new T refers to T for subsequent periods.

(2) P is the purchasing corporation.

(3) The P group is an affiliated group of which P is a member.

(4) P1, P2, etc., are domestic corporations that are members of the P group.

(5) T1, T2, etc., are domestic corporations that are target affiliates of T. These corporations (T1, T2, etc.) have only one class of stock outstanding and may also be targets.

(6) S is a domestic corporation (unrelated to P and B) that owns T prior to the purchase of T by P. (S is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by a domestic corporation.)

(7) A, a U.S. citizen or resident, is an individual (unrelated to P and B) who owns T prior to the purchase of T by P. (A is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by an individual who is a U.S. citizen or resident. Ownership of T by A and ownership of T by S are mutually exclusive circumstances.)

(8) B, a U.S. citizen or resident, is an individual (unrelated to T, S, and A) who owns the stock of P.

(9) F, used as a prefix with the other terms in this paragraph (b), connotes foreign, rather than domestic, status. For example, FT is a foreign corporation (as defined in section 7701(a)(5)) and FA is an individual other than a

U.S. citizen or resident.

(10) CFC, used as a prefix with the other terms in this paragraph (b) referring to a corporation, connotes a controlled foreign corporation (as defined in section 957, taking into account section 953(c)). A corporation identified with the prefix F may be a controlled foreign corporation. (The prefix CFC is used when the corporation's status as a controlled foreign corporation is significant.)

(d) *Time and manner of making election.* The purchasing corporation makes a section 338 election for target by filing a statement of section 338 election on Form 8023 in accordance with the instructions to the form. The section 338 election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. A section 338 election is irrevocable. See § 1.338(h)(10)-1(c)(2) for section 338(h)(10) elections.

§1.338-3 Qualification for the section 338 election.

(b) *Rules relating to qualified stock purchases —*

(1) *Purchasing corporation requirement.* An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

(2) *Purchase.* The term *purchase* has the same meaning as in section 338(h)(3). Stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock of the target (or target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock.

(3) *Acquisitions of stock from related corporations —*

(i) *In general.* Stock acquired by a purchasing corporation from a related corporation (R) is generally not considered acquired by purchase. See section 338(h)(3)(A)(iii).

(ii) *Time for testing relationship.* For purposes of section 338(h)(3)(A)(iii), a purchasing corporation is treated as related to another person if the relationship specified in section 338(h)(3)(A)(iii) exists—

(A) In the case of a single transaction, immediately after the purchase of target stock;

(B) In the case of a series of acquisitions otherwise constituting a qualified stock purchase within the meaning of section 338(d)(3), immediately after the last acquisition in such series; and

(C) In the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, immediately after the last transaction in such series.

(iii) *Cases where section 338(h)(3)(C) applies—acquisitions treated as purchases.* If section 338(h)(3)(C) applies and the purchasing corporation is treated as acquiring stock by purchase from R, solely for purposes of determining when the stock is considered acquired, target stock acquired from R is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is

first considered to own that stock under section 318(a) (other than section 318(a)(4)).

(iv) *Examples.* The following examples illustrate this paragraph (b)(3):

Example 1.

(i) S is the parent of a group of corporations that are engaged in various businesses. Prior to January 1, Year 1, S decided to discontinue its involvement in one line of business. To accomplish this, S forms a new corporation, Newco, with a nominal amount of cash. Shortly thereafter, on January 1, Year 1, S transfers all the stock of the subsidiary conducting the unwanted business (T) to Newco in exchange for 100 shares of Newco common stock and a Newco promissory note. Prior to January 1, Year 1, S and Underwriter (U) had entered into a binding agreement pursuant to which U would purchase 60 shares of Newco common stock from S and then sell those shares in an Initial Public Offering (IPO). On January 6, Year 1, the IPO closes.

(ii) Newco's acquisition of T stock is one of a series of transactions undertaken pursuant to one integrated plan. The series of transactions ends with the closing of the IPO and the transfer of all the shares of stock in accordance with the agreements. Immediately after the last transaction effected pursuant to the plan, S owns 40 percent of Newco, which does not give rise to a relationship described in section 338(h)(3)(A)(iii). See § 1.338-3(b)(3)(ii)(C). Accordingly, S and Newco are not related for purposes of section 338(h)(3)(A)(iii).

(iii) Further, because Newco's basis in the T stock is not determined by reference to S's basis in the T stock and because the transaction is not an exchange to which section 351, 354, 355, or 356 applies, Newco's acquisition of the T stock is a purchase within the meaning of section 338(h)(3).

Example 2.

(i) On January 1 of Year 1, P purchases 75 percent in value of the R stock. On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, R acquires an additional 16 shares of T stock. On December 1 of Year 1, P purchases 70 shares of T stock from an unrelated person and 12 of the 20 shares of T stock held by R.

(ii) Of the 12 shares of T stock purchased by P from R on December 1 of Year 1, 3 of those shares are deemed to have been acquired by P on January 1 of Year 1, the date on which 3 of the 4 shares of T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., 4 × .75). The remaining 9 shares of T stock purchased by P from R on December 1 of Year 1 are deemed to have been acquired by P on June 1 of Year 1, the date on which an additional 12 of the 20 shares of T stock owned by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., (20 × .75)−3). Because stock acquisitions by P sufficient for a qualified stock purchase of T occur within a 12-month period (i.e., 3 shares constructively on January 1 of Year 1, 9 shares constructively on June 1 of Year 1, and 70 shares actually on December 1 of Year 1), a qualified stock purchase is made on December 1 of Year 1.

Example 3.

(i) On February 1 of Year 1, P acquires 25 percent in value of the R stock from B (the sole shareholder of P). That R stock is not acquired by purchase. See section 338(h)(3)(A)(iii). On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, P purchases an additional 25 percent in value of the R stock, and on January 1 of Year 2, P purchases another 25 percent in value of the R stock. On June 1 of Year 2, R acquires an additional 16 shares of the T stock. On December 1 of Year 2, P purchases 68 shares of the T stock from an unrelated person and 12 of the 20 shares of the T stock held by R.

(ii) Of the 12 shares of the T stock purchased by P from R on December 1 of Year 2, 2 of those shares are deemed to have been acquired by P on June 1 of Year 1, the date on which 2 of the 4 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., 4 × .5). For purposes of this

attribution, the R stock need not be acquired by P by purchase. See section 338(h)(1). (By contrast, the acquisition of the T stock by P from R does not qualify as a purchase unless P has acquired at least 50 percent in value of the R stock by purchase. Section 338(h)(3)(C)(i).) Of the remaining 10 shares of the T stock purchased by P from R on December 1 of Year 2, 1 of those shares is deemed to have been acquired by P on January 1 of Year 2, the date on which an additional 1 share of the 4 shares of the T stock held by R on that date was first considered owned by P under section 318(a)(2)(C) (i.e., (4 × .75)−2). The remaining 9 shares of the T stock purchased by P from R on December 1 of Year 2, are deemed to have been acquired by P on June 1 of Year 2, the date on which an additional 12 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., (20 × .75)−3). Because a qualified stock purchase of T by P is made on December 1 of Year 2 only if all 12 shares of the T stock purchased by P from R on that date are considered acquired during a 12-month period ending on that date (so that, in conjunction with the 68 shares of the T stock P purchased on that date from the unrelated person, 80 of T's 100 shares are acquired by P during a 12-month period) and because 2 of those 12 shares are considered to have been acquired by P more than 12 months before December 1 of Year 2 (i.e., on June 1 of Year 1), a qualified stock purchase is not made. (Under § 1.338-8(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.)

Example 4. Assume the same facts as in *Example 3*, except that on February 1 of Year 1, P acquires 25 percent in value of the R stock by purchase. The result is the same as in *Example 3*.

(4) *Acquisition date for tiered targets —*

(i) *Stock sold in deemed asset sale.* If an election under section 338 is made for target, old target is deemed to sell target's assets and new target is deemed to acquire those assets. Under section 338(h)(3)(B), new target's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3) on the acquisition date of target. If new target's deemed purchase causes a qualified stock purchase of the other corporation and if a section 338 election is made for the other corporation, the acquisition date for the other corporation is the same as the acquisition date of target. However, the deemed sale and purchase of the other corporation's assets is considered to take place after the deemed sale and purchase of target's assets.

(ii) *Example.* The following example illustrates this paragraph (b)(4):

Example. A owns all of the T stock. T owns 50 of the 100 shares of X stock. The other 50 shares of X stock are owned by corporation Y, which is unrelated to A, T, or P. On January 1 of Year 1, P makes a qualified stock purchase of T from A and makes a section 338 election for T. On December 1 of Year 1, P purchases the 50 shares of X stock held by Y. A qualified stock purchase of X is made on December 1 of Year 1, because the deemed purchase of 50 shares of X stock by new T because of the section 338 election for T and the actual purchase of 50 shares of X stock by P are treated as purchases made by one corporation. Section 338(h)(8). For purposes of determining whether those purchases occur within a 12-month acquisition period as required by section 338(d)(3), T is deemed to purchase its X stock on T's acquisition date, i.e., January 1 of Year 1.

(5) *Effect of redemptions —*

(i) *General rule.* Except as provided in this paragraph (b)(5), a qualified stock purchase is made on the first day on which the percentage ownership requirements of section 338(d)(3) are satisfied by reference to target stock that is both—

(A) Held on that day by the purchasing corporation; and

(B) Purchased by the purchasing corporation during the 12-month period ending on that day.

(ii) *Redemptions from persons unrelated to the purchasing corporation.* Target stock redemptions from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in target's outstanding stock for purposes of determining whether target stock purchased by the purchasing corporation in the 12-month acquisition period satisfies the percentage ownership requirements of section 338(d)(3).

(iii) *Redemptions from the purchasing corporation or related persons during 12-month acquisition period —*

(A) *General rule.* For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of target stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in target's outstanding stock.

(B) *Exception for certain redemptions from related corporations.* A redemption of target stock during the 12-month acquisition period from a corporation related to the purchasing corporation is taken into account as a reduction in target's outstanding stock to the extent that the redeemed stock would have been considered purchased by the purchasing corporation (because of section 338(h)(3)(C)) during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption. See paragraph (b)(3) of this section.

(iv) *Examples.* The following examples illustrate this paragraph (b)(5):

Example 1. QSP on stock purchase date; redemption from unrelated person during 12-month period. A owns all 100 shares of T stock. On January 1 of Year 1, P purchases 40 shares of the T stock from A. On July 1 of Year 1, T redeems 25 shares from A. On December 1 of Year 1, P purchases 20 shares of the T stock from A. P makes a qualified stock purchase of T on December 1 of Year 1, because the 60 shares of T stock purchased by P within the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

Example 2. QSP on stock redemption date; redemption from unrelated person during 12-month period. The facts are the same as in *Example 1,* except that P purchases 60 shares of T stock on January 1 of Year 1 and none on December 1 of Year 1. P makes a qualified stock purchase of T on July 1 of Year 1, because that is the first day on which the T stock purchased by P within the preceding 12-month period satisfies the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

Example 3. Redemption from purchasing corporation not taken into account. On December 15 of Year 1, T redeems 30 percent of its stock from P. The redeemed stock was held by P for several years and constituted P's total interest in T. On December 1 of Year 2, P purchases the remaining T stock from A. P does not make a qualified stock purchase of T on December 1 of Year 2. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock.

Example 4. Redemption from related person taken into account. On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. For

purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased (because of section 338(h)(3)(C)(i)) during the 12-month period ending on April 1 of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See paragraph (b)(3) of this section. Accordingly, P makes a qualified stock purchase of T on April 1 of Year 1, because the 60 shares of T stock purchased by P on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/60 shares), determined by taking into account the redemption of 40 shares.

(c) *Effect of post-acquisition events on eligibility for section 338 election —*

(1) *Post-acquisition elimination of target.*

(i) The purchasing corporation may make an election under section 338 for target even though target is liquidated on or after the acquisition date. If target liquidates on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets. The purchasing corporation may also make an election under section 338 for target even though target is merged into another corporation, or otherwise disposed of by the purchasing corporation provided that, under the facts and circumstances, the purchasing corporation is considered for tax purposes as the purchaser of the target stock. See § 1.338(h)(10)-1(c)(2) for special rules concerning section 338(h)(10) elections in certain multi-step transactions.

(ii) The following examples illustrate this paragraph (c)(1):

Example 1. On January 1 of Year 1, P purchases 100 percent of the outstanding common stock of T. On June 1 of Year 1, P sells the T stock to an unrelated person. Assuming that P is considered for tax purposes as the purchaser of the T stock, P remains eligible, after June 1 of Year 1, to make a section 338 election for T that results in a deemed asset sale of T's assets on January 1 of Year 1.

Example 2. On January 1 of Year 1, P makes a qualified stock purchase of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated person. On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1 results in a qualified stock purchase by T of T1 on January 1 of Year 1. See paragraph (b)(4)(i) of this section.

(2) *Post-acquisition elimination of the purchasing corporation.* An election under section 338 may be made for target after the acquisition of assets of the purchasing corporation by another corporation in a transaction described in section 381(a), provided that the purchasing corporation is considered for tax purposes as the purchaser of the target stock. The acquiring corporation in the section 381(a) transaction may make an election under section 338 for target.

§1.338-4 Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.

(a) *Scope.* This section provides rules under section 338(a)(1) to determine the aggregate deemed sale price (ADSP) for target. ADSP is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. ADSP is allocated among target's assets in accordance with § 1.338-6 to determine the amount for which each asset is deemed to have been sold. When a subsequent increase or decrease is required under general

principles of tax law with respect to an element of ADSP, the redetermined ADSP is allocated among target's assets in accordance with § 1.338-7. This § 1.338-4 also provides rules regarding the recognition of gain or loss on the deemed sale of target affiliate stock. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation of section 338.

(b) *Determination of ADSP —*

(1) *General rule.* ADSP is the sum of—

(i) The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A)); and

(ii) The liabilities of old target.

(2) *Time and amount of ADSP —*

(i) *Original determination.* ADSP is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of ADSP.

(ii) *Redetermination of ADSP.* ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. For example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock or because liabilities not originally taken into account in determining ADSP are subsequently taken into account. Increases or decreases with respect to the elements of ADSP result in the reallocation of ADSP among target's assets under § 1.338-7.

(iii) *Example.* The following example illustrates this paragraph (b)(2):

Example. In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of $100,000. P acquires all of the stock of T in Year 3 for $700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to $80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See § 1.338-5(b)(2)(iii) *Example 1* for the effect on AGUB.

(c) *Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock —*

(1) *Determination of amount.* The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock is an amount equal to—

(i) The amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics and the installment method were not available and determined

without regard to the selling costs taken into account under paragraph (c)(1)(iii) of this section;

(ii) Divided by the percentage of target stock (by value, determined on the acquisition date) attributable to that recently purchased target stock;

(iii) Less the selling costs incurred by the selling shareholders in connection with the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock).

(2) *Example.* The following example illustrates this paragraph (c):

Example. T has two classes of stock outstanding, voting common stock and preferred stock described in section 1504(a)(4). On March 1 of Year 1, P purchases 40 percent of the outstanding T stock from S1 for $500, 20 percent of the outstanding T stock from S2 for $225, and 20 percent of the outstanding T stock from S3 for $275. On that date, the fair market value of all the T voting common stock is $1,250 and the preferred stock $750. S1, S2, and S3 incur $40, $35, and $25 respectively of selling costs. S1 continues to own the remaining 20 percent of the outstanding T stock. The grossed-up amount realized on the sale to P of P's recently purchased T stock is calculated as follows: The total amount realized (without regard to selling costs) is $1,000 (500 + 225 + 275). The percentage of T stock by value on the acquisition date attributable to the recently purchased T stock is 50% (1,000/(1,250 + 750)). The selling costs are $100 (40 + 35 + 25). The grossed-up amount realized is $1,900 (1,000/.5 – 100).

(d) *Liabilities of old target —*

(1) *In general.* In general, the liabilities of old target are measured as of the beginning of the day after the acquisition date. (But see § 1.338-1(d) (regarding certain transactions on the acquisition date).) In order to be taken into account in ADSP, a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. See § 1.1001-2(a). Such liabilities may include liabilities for the tax consequences resulting from the deemed sale.

(2) *Time and amount of liabilities.* The time for taking into account liabilities of old target in determining ADSP and the amount of the liabilities taken into account is determined as if old target had sold its assets to an unrelated person for consideration that included the discharge of the liabilities by the unrelated person. For example, if no amount of a target liability is properly taken into account in amount realized as of the beginning of the day after the acquisition date, the liability is not initially taken into account in determining ADSP (although it may be taken into account at some later date).

(e) *Deemed sale tax consequences.* Gain or loss on each asset in the deemed sale is computed by reference to the ADSP allocated to that asset. ADSP is allocated under the rules of § 1.338-6. Though deemed sale tax consequences may increase or decrease ADSP by creating or reducing a tax liability, the amount of the tax liability itself may be a function of the size of the deemed sale tax consequences. Thus, these determinations may require trial and error computations.

§1.338-10 Filing of returns.

(a) *Returns including tax liability from deemed asset sale —*

(1) *In general.* Except as provided in paragraphs (a)(2) and (3) of this section, any deemed sale tax consequences are reported on the final return of old target filed for old target's taxable year that ends at the

close of the acquisition date. Paragraphs (a)(2), (3) and (4) of this section do not apply to elections under section 338(h)(10). If old target is the common parent of an affiliated group, the final return may be a consolidated return (any such consolidated return must also include any deemed sale tax consequences of any members of the consolidated group that are acquired by the purchasing corporation on the same acquisition date as old target).

(2) *Old target's final taxable year otherwise included in consolidated return of selling group —*

(i) *General rule.* If the selling group files a consolidated return for the period that includes the acquisition date, old target is disaffiliated from that group immediately before the deemed asset sale and must file a deemed sale return separate from the group, which includes only the deemed sale tax consequences and the carryover items specified in paragraph (a)(2)(iii) of this section. The deemed asset sale occurs at the close of the acquisition date and is the last transaction of old target and the only transaction reported on the separate return. Except as provided in § 1.338-1(d) (regarding certain transactions on the acquisition date), any transactions of old target occurring on the acquisition date other than the deemed asset sale are included in the selling group's consolidated return. A deemed sale return includes a combined deemed sale return as defined in paragraph (a)(4) of this section.

(ii) *Separate taxable year.* The deemed asset sale included in the deemed sale return under this paragraph (a)(2) occurs in a separate taxable year, except that old target's taxable year of the sale and the consolidated year of the selling group that includes the acquisition date are treated as the same year for purposes of determining the number of years in a carryover or carryback period.

(iii) *Carryover and carryback of tax attributes.* Target's attributes may be carried over to, and carried back from, the deemed sale return under the rules applicable to a corporation that ceases to be a member of a consolidated group.

(iv) *Old target is a component member of purchasing corporation's controlled group.* For purposes of its deemed sale return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(4) *Combined deemed sale return —*

(i) *General rule.* Under section 338(h)(15), a combined deemed sale return (combined return) may be filed for all targets from a single selling consolidated group (as defined in § 1.338(h)(10)-1(b)(3)) that are acquired by the purchasing corporation on the same acquisition date and that otherwise would be required to file separate deemed sale returns. The combined return must include all such targets. For example, T and T1 may be included in a combined return if—

(A) T and T1 are directly owned subsidiaries of S;

(B) S is the common parent of a consolidated group; and

(C) P makes qualified stock purchases of T and T1 on the same acquisition date.

(ii) *Gain and loss offsets.* Gains and losses recognized on the deemed asset sales by targets included in a combined return are treated as the gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the separate return limitation year restrictions (SRLY restrictions) of the consolidated return regulations while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return. If, however, a

target has loss carryovers that were subject to the SRLY restrictions while that target was a member of the selling consolidated group, the use of those losses in the combined return continues to be subject to those restrictions, applied in the same manner as if the combined return were a consolidated return. A similar rule applies, when appropriate, to other tax attributes.

(iii) *Procedure for filing a combined return.* A combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all targets required to be included in the combined return. The combined return reflects the deemed asset sales of all targets required to be included in the combined return. If the targets included in the combined return constitute a single affiliated group within the meaning of section 1504(a), the income tax return is signed by an officer of the common parent of that group. Otherwise, the return must be signed by an officer of each target included in the combined return. Rules similar to the rules in § 1.1502-75(j) apply for purposes of preparing the combined return. The combined return must include a statement entitled, "ELECTION TO FILE A COMBINED RETURN UNDER SECTION 338(h)(15)." The statement must include—

(A) The name, address, and employer identification number of each target required to be included in the combined return; and

(B) The following declaration: EACH TARGET IDENTIFIED IN THIS ELECTION TO FILE A COMBINED RETURN CONSENTS TO THE FILING OF A COMBINED RETURN.

(iv) *Consequences of filing a combined return.* Each target included in a combined return is severally liable for any tax associated with the combined return. See § 1.338-1(b)(3).

(5) *Deemed sale excluded from purchasing corporation's consolidated return.* Old target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to its deemed asset sale.

(6) *Due date for old target's final return —*

(i) *General rule.* Old target's final return is generally due on the 15th day of the third calendar month following the month in which the acquisition date occurs. See section 6072 (time for filing income tax returns).

(ii) *Application of § 1.1502-76(c) —*

(A) *In general.* Section 1.1502-76(c) applies to old target's final return if old target was a member of a selling group that did not file consolidated returns for the taxable year of the common parent that precedes the year that includes old target's acquisition date. If the selling group has not filed a consolidated return that includes old target's taxable period that ends on the acquisition date, target may, on or before the final return due date (including extensions), either—

(*1*) File a deemed sale return on the assumption that the selling group will file the consolidated return; or

(*2*) File a return for so much of old target's taxable period as ends at the close of the acquisition date on the assumption that the consolidated return will not be filed.

(B) *Deemed extension.* For purposes of applying § 1.1502-76(c)(2), an extension of time to file old target's final return is considered to be in effect until the last date for making the election under section

338.

(C) *Erroneous filing of deemed sale return.* If, under this paragraph (a)(6)(ii), target files a deemed sale return but the selling group does not file a consolidated return, target must file a substituted return for old target not later than the due date (including extensions) for the return of the common parent with which old target would have been included in the consolidated return. The substituted return is for so much of old target's taxable year as ends at the close of the acquisition date. Under § 1.1502-76(c)(2), the deemed sale return is not considered a return for purposes of section 6011 (relating to the general requirement of filing a return) if a substituted return must be filed.

(D) *Erroneous filing of return for regular tax year.* If, under this paragraph (a)(6)(ii), target files a return for so much of old target's regular taxable year as ends at the close of the acquisition date but the selling group files a consolidated return, target must file an amended return for old target not later than the due date (including extensions) for the selling group's consolidated return. (The amended return is a deemed sale return.)

(E) *Last date for payment of tax.* If either a substituted or amended final return of old target is filed under this paragraph (a)(6)(ii), the last date prescribed for payment of tax is the final return due date (as defined in paragraph (a)(6)(i) of this section).

(7) *Examples.* The following examples illustrate this paragraph (a):

Example 1.

(i) S is the common parent of a consolidated group that includes T. The S group files calendar year consolidated returns. At the close of June 30 of Year 1, P makes a qualified stock purchase of T from S. P makes a section 338 election for T, and T's deemed asset sale occurs as of the close of T's acquisition date (June 30).

(ii) T is considered disaffiliated for purposes of reporting the deemed sale tax consequences. Accordingly, T is included in the S group's consolidated return through T's acquisition date except that the tax liability for the deemed sale tax consequences is reported in a separate deemed sale return of T. Provided that T is not treated as an excluded member under section 1563(b)(2), T is a component member of P's controlled group for the taxable year of the deemed asset sale, and the taxable income bracket amounts available in calculating tax on the deemed sale return must be limited accordingly.

(iii) If P purchased the stock of T at 10 a.m. on June 30 of Year 1, the results would be the same. See paragraph (a)(2)(i) of this section.

Example 2. The facts are the same as in *Example 1*, except that the S group does not file consolidated returns. T must file a separate return for its taxable year ending on June 30 of Year 1, which return includes the deemed asset sale.

§1.338(h)(10)-1 Deemed asset sale and liquidation.

(b) *Definitions —*

(1) *Consolidated target.* A *consolidated target* is a target that is a member of a consolidated group within the meaning of § 1.1502-1(h) on the acquisition date and is not the common parent of the group on that date.

(2) *Selling consolidated group.* A *selling consolidated group* is the consolidated group of which the consolidated target is a member on the acquisition date.

(3) *Selling affiliate; affiliated target.* A *selling affiliate* is a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2), and does not join in filing a consolidated return with the target. In such case, the target is an *affiliated target.*

(4) *S corporation target.* An *S corporation target* is a target that is an S corporation immediately before the acquisition date.

(5) *S corporation shareholders. S corporation shareholders* are the S corporation target's shareholders. Unless otherwise indicated, a reference to S corporation shareholders refers both to S corporation shareholders who do and those who do not sell their target stock.

(6) *Liquidation.* Any reference in this section to a *liquidation* is treated as a reference to the transfer described in paragraph (d)(4) of this section notwithstanding its ultimate characterization for Federal income tax purposes.

(c) *Section 338(h)(10) election —*

(1) *In general.* A section 338(h)(10) election may be made for T if P acquires stock meeting the requirements of section 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase.

(2) *Availability of section 338(h)(10) election in certain multi-step transactions.* Notwithstanding anything to the contrary in § 1.338-3(c)(1)(i), a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P), whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition of the T stock and the merger or liquidation of T qualify as a reorganization described in section 368(a). If a section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and is not treated as part of a reorganization described in section 368(a).

(3) *Simultaneous joint election requirement.* A section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. S corporation shareholders who do not sell their stock must also consent to the election. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(4) *Irrevocability.* A section 338(h)(10) election is irrevocable. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T.

(5) *Effect of invalid election.* If a section 338(h)(10) election for T is not valid, the section 338 election for T is also not valid.

(d) *Certain consequences of section 338(h)(10) election.* For purposes of subtitle A of the Internal Revenue Code (except as provided in § 1.338-1(b)(2)), the consequences to the parties of making a section 338(h)(10) election for T are as follows:

(1) *P.* P is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock, if any. The effect of a gain recognition election includes a taxable deemed sale by P on the acquisition date of any nonrecently purchased target stock. See § 1.338-5(d).

(2) *New T.* The AGUB for new T's assets is determined under § 1.338-5 and is allocated among the acquisition date assets under §§ 1.338-6 and 1.338-7. Notwithstanding paragraph (d)(4) of this section (deemed liquidation of old T), new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale tax consequences). For example, new T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See § 1.1502-6(a).

(3) *Old T—deemed sale —*

(i) *In general.* Old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). See § 1.338-1(a) regarding the tax characterization of the deemed asset sale. Except as provided in § 1.338(h)(10)-1(d)(8) (regarding the installment method), old T recognizes all of the gain realized on the deemed transfer of its assets in consideration for the ADSP. ADSP for old T is determined under § 1.338-4 and allocated among the acquisition date assets under §§ 1.338-6 and 1.338-7. Old T realizes the deemed sale tax consequences from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders). If T is an affiliated target, or an S corporation target, the principles of §§ 1.338-2(c)(10) and 1.338-10(a)(1), (5), and (6)(i) apply to the return on which the deemed sale tax consequences are reported. When T is an S corporation target, T's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation) notwithstanding section 1362(d)(2)(B). Also, when T is an S corporation target (but not a qualified subchapter S subsidiary), any direct and indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close of the acquisition date.

(ii) *Tiered targets.* In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed asset sale of a parent corporation is considered to precede that of its subsidiary. See § 1.338-3(b)(4)(i).

(4) *Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization —*

(i) *In general.* Old T is treated as if, before the close of the acquisition date, after the deemed asset sale in paragraph (d)(3) of this section, and while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders), it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 336 or 337 applies.

(ii) *Tiered targets.* In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed liquidation of a subsidiary corporation is considered to precede the deemed

liquidation of its parent.

(5) *Selling consolidated group, selling affiliate, or S corporation shareholders —*

(i) *In general.* If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

(ii) *Basis and holding period of T stock not acquired.* A member of the selling consolidated group (or the selling affiliate or an S corporation shareholder) retaining T stock is treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. The holding period for the retained stock starts on the day after the acquisition date. For purposes of this paragraph, the fair market value of all of the T stock equals the grossed-up amount realized on the sale to P of P's recently purchased target stock. See § 1.338-4(c).

(iii) *T stock sale.* Members of the selling consolidated group (or the selling affiliate or S corporation shareholders) recognize no gain or loss on the sale or exchange of T stock included in the qualified stock purchase (although they may recognize gain or loss on the T stock in the deemed liquidation).

(6) *Nonselling minority shareholders other than nonselling S corporation shareholders —*

(i) *In general.* This paragraph (d)(6) describes the treatment of shareholders of old T other than the following: Members of the selling consolidated group, the selling affiliate, S corporation shareholders (whether or not they sell their stock), and P. For a description of the treatment of S corporation shareholders, see paragraph (d)(5) of this section. A shareholder to which this paragraph (d)(6) applies is called a minority shareholder.

(ii) *T stock sale.* A minority shareholder recognizes gain or loss on the shareholder's sale or exchange of T stock included in the qualified stock purchase.

(iii) *T stock not acquired.* A minority shareholder does not recognize gain or loss under this section with respect to shares of T stock retained by the shareholder. The shareholder's basis and holding period for that T stock is not affected by the section 338(h)(10) election.

(7) *Consolidated return of selling consolidated group.* If P acquires T in a qualified stock purchase from a selling consolidated group—

(i) The selling consolidated group must file a consolidated return for the taxable period that includes the acquisition date;

(ii) A consolidated return for the selling consolidated group for that period may not be withdrawn on or after the day that a section 338(h)(10) election is made for T; and

(iii) Permission to discontinue filing consolidated returns cannot be granted for, and cannot apply to, that period or any of the immediately preceding taxable periods during which consolidated returns continuously have been filed.

(8) *Availability of the section 453 installment method.* Solely for purposes of applying sections 453, 453A, and 453B, and the regulations thereunder (the installment method) to determine the consequences to old T in the deemed asset sale and to old T (and its shareholders, if relevant) in the deemed liquidation, the rules in paragraphs (d)(1) through (7) of this section are modified as follows:

(i) *In deemed asset sale.* Old T is treated as receiving in the deemed asset sale new T installment obligations, the terms of which are identical (except as to the obligor) to P installment obligations issued in exchange for recently purchased stock of T. Old T is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, old T liabilities. For example, old T is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under § 1.338-4(c). The amount realized for recently purchased stock taken into account in determining ADSP is adjusted (and, thus, ADSP is redetermined) to reflect the amounts paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

(ii) *In deemed liquidation.* Old T is treated as distributing in the deemed liquidation the new T installment obligations that it is treated as receiving in the deemed asset sale. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving in the deemed liquidation the new T installment obligations that correspond to the P installment obligations they actually received individually in exchange for their recently purchased stock. The new T installment obligations may be recharacterized under other rules. See for example § 1.453-11(a)(2) which, in certain circumstances, treats the new T installment obligations deemed distributed by old T as if they were issued by new T in exchange for the stock in old T owned by members of the selling consolidated group, the selling affiliate, or the S corporation shareholders. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

(9) *Treatment consistent with an actual asset sale.* No provision in section 338(h)(10) or this section shall produce a Federal income tax result under subtitle A of the Internal Revenue Code that would not occur if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. See, however, § 1.338-1(b)(2) for certain exceptions to this rule.

§1.351-1 Transfer to corporation controlled by transferor.

(a) *In general —*

(1) *Nonrecognition of gain or loss.* Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock of such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase “one or more persons” includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see section 7701(a)(1)). To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase “immediately after the exchange” does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this

section, stock rights and stock warrants are not included in the term *stock.* In addition, for purposes of this section—

(i) Stock will not be treated as issued for property if it is issued for services rendered or to be rendered to or for the benefit of the issuing corporation; and

(ii) Stock will not be treated as issued for property if it is issued for property which is of relatively small value in comparison to the value of the stock already owned (or to be received for services) by the person who transferred such property and the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

(2) *Application.* The application of section 351(a) is illustrated by the following examples:

Example 1. C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example 2. B owns certain real estate which cost him $50,000 in 1930, but which has a fair market value of $200,000 in 1955. He transfers the property to the N Corporation in 1955 for 78 percent of each class of stock of the corporation having a fair market value of $200,000, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1940 to other persons for cash. B realized a taxable gain of $150,000 on this transaction.

Example 3. E, an individual, owns property with a basis of $10,000 but which has a fair market value of $18,000. E also had rendered services valued at $2,000 to Corporation F. Corporation F has outstanding 100 shares of common stock all of which are held by G. Corporation F issues 400 shares of its common stock (having a fair market value of $20,000) to E in exchange for his property worth $18,000 and in compensation for the services he has rendered worth $2,000. Since immediately after the transaction, E owns 80 percent of the outstanding stock of Corporation F, no gain is recognized upon the exchange of the property for the stock. However, E realized $2,000 of ordinary income as compensation for services rendered to Corporation F.

(3) *Underwritings of stock —*

(i) *In general.* For the purpose of section 351, if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

(ii) *Effective date.* This paragraph (a)(3) is effective for qualified underwriting transactions occurring on or after May 1, 1996.

§1.355-1 Distribution of stock and securities of a controlled corporation.

(b) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to (or the inclusion in income of) the shareholders and security holders, of one or more existing businesses formerly operated, directly or indirectly, by a single corporation (the “distributing corporation”). It applies only to the

separation of existing businesses that have been in active operation for at least five years (or a business that has been in active operation for at least five years into separate businesses), and which, in general, have been owned, directly or indirectly, for at least five years by the distributing corporation. A separation is achieved through the distribution by the distributing corporation of stock, or stock and securities, of one or more subsidiaries (the "controlled corporations") to its shareholders with respect to its stock or to its security holders in exchange for its securities. The controlled corporations may be preexisting or newly created subsidiaries. Throughout the regulations under section 355, the term *distribution* refers to a distribution by the distributing corporation of stock, or stock and securities, of one or more controlled corporations, unless the context indicates otherwise. Section 355 contemplates the continued operation of the business or businesses existing prior to the separation. See § 1.355-4 for types of distributions that may qualify under section 355, including pro rata distributions and non pro rata distributions.

§1.355-2 Limitations.

(b) *Independent business purpose —*

(1) *Independent business purpose requirement.* Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.

(2) *Corporate business purpose.* A corporate business purpose is a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group (as defined in § 1.355-3(b)(4)(iv)) to which the distributing corporation belongs. A purpose of reducing non Federal taxes is not a corporate business purpose if

(i) the transaction will effect a reduction in both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction and

(ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes. See *Examples (7) and (8) of paragraph (b)(5) of this section. A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for one or more corporate business purposes. See Example (2)* of paragraph (b)(5) of this section.

(3) *Business purpose for distribution.* The distribution must be carried out for one or more corporate business purposes. See *Example* (3) of paragraph (b)(5) of this section. If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that corporate business purpose. See *Examples (3)* and (*4*) of paragraph (b)(5) of this section. For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), *See* § 1.368-1(b).

(4) *Business purpose as evidence of nondevice.* The corporate business purpose or purposes for a transaction are evidence that the transaction was not used principally as a device for the distribution of earnings and profits within the meaning of section 355(a)(1)(B). *See* paragraph (d)(3)(ii) of this section.

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

Example 1. Corporation X is engaged in the production, transportation, and refining of petroleum products. In 1985, X acquires all of the properties of corporation Z, which is also engaged in the production, transportation, and refining of petroleum products. In 1991, as a result of antitrust litigation, X is ordered to divest itself of all of the properties acquired from Z. X transfers those properties to new corporation Y and distributes the stock of Y pro rata to X's shareholders. In view of the divestiture order, the distribution is carried out for a corporate business purpose. See paragraph (b)(1) of this section.

Example 2. Corporation X is engaged in two businesses: The manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B anticipate that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes. See paragraph (b)(2) of this section.

Example 3. Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example 4. Corporation X is engaged in a regulated business in State T. X owns all of the stock of corporation Y, a profitable corporation that is not engaged in a regulated business. Commission C sets the rates that X may charge its customers, based on its total income. C has recently adopted rules according to which the total income of a corporation includes the income of a business if, and only if, the business is operated, directly or indirectly, by the corporation. Total income, for this purpose, includes the income of a wholly owned subsidiary corporation but does not include the income of a parent or “brother/sister” corporation. Under C's new rule, X's total income includes the income of Y, with the result that X has suffered a reduction of the rates that it may charge its customers. It would not be impractical or unduly expensive to create in a nontaxable transaction (such as a transaction qualifying under section 351) a holding company to hold the stock of X and Y. X distributes the stock of Y to X's shareholders. The distribution is not carried out for the purpose of increasing the rates that X may charge its customers because that purpose could be achieved through a nontaxable transaction, the creation of a holding company, that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive. See paragraph (b)(3) of this section.

Example 5. The facts are the same as in *Example (4),* except that C has recently adopted rules according to which the total income of a corporation includes not only the income included in *Example (3),* but also the income of any member of the affiliated group to which the corporation belongs. In order to avoid a reduction in the rates that it may charge its customers, X distributes the stock of Y to X's shareholders. The distribution is carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example 6.

(i) Corporation X owns all of the one class of stock of corporation Y. X distributes the stock of Y pro rata to its five shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

(ii) The facts are the same as in *Example 6(i),* except that the business of Y is operated as a division of X. X transfers this division to new corporation Y and distributes the stock of Y pro rata to its shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

Example 7. The facts are the same as in *Example (6)(i),* except that the distribution is made to enable X to elect to become an S corporation both for Federal tax purposes and for purposes of the income tax imposed by State M. State M has tax law provisions similar to subchapter S of the Internal Revenue Code of 1986. An election to be an S corporation for Federal tax purposes will effect a substantial reduction in Federal taxes that is greater than the reduction of State M taxes pursuant to an election to be an S corporation for State M purposes. The purpose of reducing State M taxes is not a corporate business purpose. The distribution does not meet the corporate business purpose requirements. See paragraph (b)(1) and (2) of this section.

Example 8. The facts are the same as *Example (7),* except that the distribution also is made to enable *A,* a key employee of Y, to acquire stock of Y without investing in X. A is considered to be critical to the success of Y and he has indicated that he will seriously consider leaving the company if he is not given the opportunity to purchase a significant amount of stock of Y. As a matter of state law, Y could not issue stock to the employee while it was a subsidiary of X. As in *Example (7),* the purpose of reducing State M taxes is not a corporate business purpose. In order to determine whether the issuance of stock to the key employee, in fact, motivated the distribution of the Y stock, the potential avoidance of Federal taxes is a relevant factor to take into account. If the facts and circumstances establish that the distribution was substantially motivated by the need to issue stock to the employee, the distribution will meet the corporate business purpose requirement.

§1.355-3 Active conduct of a trade or business.

(a) *General requirements —*

(1) *Application of section 355.* Under section 355(b)(1), a distribution of stock, or stock and securities, of a controlled corporation qualifies under section 355 only if—

(i) The distributing and the controlled corporations are each engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(A)), or

(ii) Immediately before the distribution, the distributing corporation had no assets other than stock or securities of the controlled corporations, and each of the controlled corporations is engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(B)). A *de minimis* amount of assets held by the distributing corporation shall be disregarded for purposes of this paragraph (a)(1)(ii).

(2) *Examples.* Paragraph (a)(1) of this section may be illustrated by the following examples:

Example 1. Prior to the distribution, corporation X is engaged in the active conduct of a trade or business and owns all of the stock of corporation Y, which also is engaged in the active conduct of a trade or business. X distributes all of the stock of Y to X's shareholders, and each corporation continues the active conduct of its trade or business. The active business requirement of section 355(b)(1)(A) is satisfied.

Example 2. The facts are the same as in *Example (1),* except that X transfers all of its assets other than the stock of Y to a new corporation in exchange for all of the stock of the new corporation and then distributes the stock of both controlled corporations to X's shareholders. The active business requirement of section 355(b)(1)(B) is satisfied.

(b) *Active conduct of a trade or business defined —*

(1) *In general.* Section 355(b)(2) provides rules for determining whether a corporation is treated as engaged in the active conduct of a trade or business for purposes of section 355(b)(1). Under section 355(b)(2)(A), a corporation is treated as engaged in the active conduct of a trade or business if it is itself engaged in the active conduct of a trade or business or if substantially all of its assets consist of the stock, or stock and securities, of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

(2) *Active conduct of a trade or business immediately after distribution —*

(i) *In general.* For purposes of section 355(b), a corporation shall be treated as engaged in the "active conduct of a trade or business" immediately after the distribution if the assets and activities of the corporation satisfy the requirements and limitations described in paragraph (b)(2)(ii), (iii), and (iv) of this section.

(ii) *Trade or business.* A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

(iii) *Active conduct.* For purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others. Separations of real property all or substantially all of which is occupied prior to the distribution by the distributing or the controlled corporation (or by any corporation controlled directly or indirectly by either of those corporations) will be carefully scrutinized with respect to the requirements of section 355(b) and this § 1.355-3.

(iv) *Limitations.* The active conduct of a trade or business does not include—

(A) The holding for investment purposes of stock, securities, land, or other property, or

(B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

(3) *Active conduct for five-year period preceding distribution.* Under section 355(b)(2)(B), a trade or business that is relied upon to meet the requirements of section 355(b) must have been actively conducted throughout the five-year period ending on the date of the distribution. For purposes of this subparagraph (3)—

(i) Activities which constitute a trade or business under the tests described in paragraph (b)(2) of this section shall be treated as meeting the requirement of the preceding sentence if such activities were actively conducted throughout the 5-year period ending on the date of distribution, and

(ii) The fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.

(4) *Special rules for acquisition of a trade or business (Prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988) —*

(i) *In general.* Under section 355(b)(2)(C), a trade or business relied upon to meet the requirements of section 355(b) must not have been acquired by the distributing corporation, the controlled corporation, or another member of the affiliated group during the five-year period ending on the date of the distribution unless it was acquired in a transaction in which no gain or loss was recognized. Similarly, under section 355(b)(2)(D), the trade or business must not have been indirectly acquired by any of those corporations (or a predecessor in interest of any of those corporations) during that five-year period in a transaction in which gain or loss was recognized in whole or in part and which consisted of the acquisition of control of the corporation directly engaged in the trade or business, or the indirect acquisition of control of that corporation through the direct or indirect acquisition of control of one or more other corporations. A trade or business acquired, directly or indirectly, within the five-year period ending on the date of the distribution in a transaction in which the basis of the assets acquired was not determined in whole or in part by reference to the transferor's basis does not qualify under section 355(b)(2), even though no gain or loss was recognized by the transferor.

(ii) *Example.* Paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. In 1985, corporation X, which operates a business and has cash and other liquid assets, purchases all of the stock of corporation Y, which is engaged in the active conduct of a trade or business. Later in the same year, X merges into Y in a “downstream” statutory merger. In 1986, Y transfers the business assets formerly owned by X to a new subsidiary, corporation Z, and then distributes the stock of Z to Y's shareholders. Section 355 does not apply to the distribution of the stock of Z because the trade or business of Y was indirectly acquired by X, a predecessor in interest of Y, during the five-year period preceding the distribution.

(iii) *Gain or loss recognized in certain transactions.* The requirements of section 355(b)(2)(C) and (D) are intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a distribution by the corporation of that trade of business in a distribution to which section 355 would otherwise apply. A direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355(b)(2)(C) or (D), such an acquisition, even

though taxable, shall be disregarded.

(iv) *Affiliated group.* For purposes of this subparagraph (4), the term *affiliated group* means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term *stock* includes nonvoting stock described in section 1504(a)(4).

(5) *Special rules for acquisition of a trade or business (After the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).* [Reserved]

(c) *Examples.* The following examples illustrate section 355(b)(2)(A) and (B) and paragraph (b)(1), (2), and (3) of this section. However, a transaction that satisfies these active business requirements will qualify under section 355 only if it satisfies the other requirements of section 355 (a) and (b).

Example 1. Corporation X is engaged in the manufacture and sale of soap and detergents and also owns investment securities. X transfers the investment securities to new subsidiary Y and distributes the stocks of Y to X's shareholders. Y does not satisfy the requirements of section 355(b) because the holding of investment securities does not constitute the active conduct of a trade or business. See paragraph (b)(2)(iv)(A) of this section.

Example 2. Corporation X owns, manages, and derives rental income from an office building and also owns vacant land. X transfers the land to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will subdivide the land, install streets and utilities, and sell the developed lots to various homebuilders. Y does not satisfy the requirements of section 355(b) because no significant development activities were conducted with respect to the land during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example 3. Corporation X owns land on which it conducts a ranching business. Oil has been discovered in the area, and it is apparent that oil may be found under the land on which the ranching business is conducted. X has engaged in no significant activities in connection with its mineral rights. X transfers its mineral rights to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will actively pursue the development of the oil producing potential of the property. Y does not satisfy the requirements of section 355(b) because X engaged in no significant exploitation activities with respect to the mineral rights during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example 4. For more than five years, corporation X has conducted a single business of constructing sewage disposal plants and other facilities. X transfers one-half of its assets to new subsidiary Y. These assets include a contract for the construction of a sewage disposal plant in State M, construction equipment, cash, and other tangible assets. X retains a contract for the construction of a sewage disposal plant in State N, construction equipment, cash, and other intangible assets. X then distributes the stock of Y to one of X's shareholders in exchange for all of his stock of X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example 5. For the past six years, corporation X has owned and operated two factories devoted to the production of edible pork skins. The entire output of one factory is sold to one customer, C, while the output of the second factory is sold to C and a number of other customers. To eliminate errors in packaging, X opens a new factory. Thereafter, orders from C are processed and packaged at the two original factories, while the new factory handles only orders from other customers. Eight months after opening the new factory, X transfers it and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example 6. Corporation X has owned and operated a men's retail clothing store in the downtown area of the City of G for nine years and has owned and operated another men's retail clothing store in a suburban area of G for seven years. X transfers the store building, fixtures, inventory, and other assets related to the operations of the suburban store to new subsidiary Y. X also transfers to Y the delivery trucks and delivery personnel that formerly served both stores. Henceforth, X will contract with a local public delivery service to make its deliveries. X retains the warehouses that formerly served both stores. Henceforth, Y will lease warehouse space from an unrelated public warehouse company. X then distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example 7. For the past nine years, corporation X has owned and operated a department store in the downtown area of the City of G. Three years ago, X acquired a parcel of land in a suburban area of G and constructed a new department store on it. X transfers the suburban store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, each store has its own manager and is operated independently of the other store. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example 8. For the past six years, corporation X has owned and operated hardware stores in several states. Two years ago, X purchased all of the assets of a hardware store in State M, where X had not previously conducted business. X transfers the State M store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, the State M store has its own manager and is operated independently of the other stores. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example 9. For the past eight years, corporation X has engaged in the manufacture and sale of household products. Throughout this period, X has maintained a research department for use in connection with its manufacturing activities. The research department has 30 employees actively engaged in the development of new products. X transfers the research department to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, Y continues its research operations on a contractual basis with several corporations, including X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. The result in this example is the same if, after the distribution, Y continues its research operations but furnishes its services only to X. See paragraph (b)(3)(i) of this section. However, see § 1.355-2 (d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example 10. For the past six years, corporation X has processed and sold meat products. X derives income from no other source. X separates the sales function from the processing function by transferring the business assets related to the sales function and cash for working capital to new subsidiary Y. X then distributes the stock of Y to X's shareholders. After the distribution, Y purchases for resale the meat products processed by X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. However, see § 1.355-2(d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example 11. For the past eight years, corporation X has been engaged in the manufacture and sale of steel and steel products. X owns all of the stock of corporation Y, which, for the past six years, has owned and operated a coal mine for the sole purpose of supplying X's coal requirements in the manufacture of steel. X distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355 (b). See paragraph (b)(3)(i) of this section. However, see § 1.355-2 (d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example 12. For the past seven years, corporation X, a bank, has owned an eleven-story office building, the ground floor of which X has occupied in the conduct of its banking business. The remaining ten floors are rented to various tenants. Throughout this seven-year period, the building has been managed and maintained by employees of the bank. X transfers the building to new subsidiary Y and distributes the stock of Y to X's

shareholders. Henceforth, Y will manage the building, negotiate leases, seek new tenants, and repair and maintain the building. X and Y both satisfy the requirements of section 355 (b). See paragraph (b)(3) of this section.

Example 13. For the past nine years, corporation X, a bank, has owned a two-story building, the ground floor and one half of the second floor of which X has occupied in the conduct of its banking business. The other half of the second floor has been rented as storage space to a neighboring retail merchant. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, X leases from Y the space in the building that it formerly occupied. Under the lease, X will repair and maintain its portion of the building and pay property taxes and insurance. Y does not satisfy the requirements of section 355 (b) because it is not engaged in the active conduct of a trade or business immediately after the distribution. See paragraph (b)(2)(iv)(A) of this section. This example does not address the question of whether the activities of X with respect to the building prior to the separation would constitute the active conduct of a trade or business.

§1.357-1 Assumption of liability.

(a) *General rule.* Section 357(a) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 1001 upon an exchange. Section 357(a) provides, subject to the exceptions and limitations specified in section 357 (b) and (c), that—

(1) Liabilities assumed are not to be treated as “other property or money” for the purpose of determining the amount of realized gain which is to be recognized under section 351, 361, 371, or 374, if the transactions would, but for the receipt of “other property or money” have been exchanges of the type described in any one of such sections; and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 351, 361, 371, or 374, consists of an assumption of liabilities, the transaction, if otherwise qualified, will be deemed to be within the provisions of section 351, 361, 371, or 374.

(b) *Application of general rule.* The application of paragraph (a) of this section may be illustrated by the following example:

Example.

A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, $3,000 cash, and the assumption by the corporation of indebtedness of A amounting to $4,000. A's gain is $5,000, computed as follows:

Stock received, fair market value	$8,000
Cash received	3,000
Liability assumed by transferee	4,000
Total consideration received	15,000
Less: Adjusted basis of property transferred	10,000
Gain realized	5,000

Assuming that the exchange falls within section 351 as a transaction in which the gain to be recognized is limited to “other property or money” received, the gain recognized to A will be limited to the $3,000 cash received,

since, under the general rule of section 357(a), the assumption of the $4,000 liability does not constitute "other property."

(c) *Tax avoidance purpose.* The benefits of section 357(a) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the total amount of liabilities assumed or acquired pursuant to such exchange (and not merely a particular liability with respect to which the tax avoidance purpose existed) shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed or acquired, be treated as money received by the taxpayer upon the exchange. Thus, if in the example set forth in paragraph (b) of this section, the principal purpose of the assumption of the $4,000 liability was to avoid tax on the exchange, or was not a bona fide business purpose, then the amount of gain recognized would be $5,000. In any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as "other property or money" under section 357, which is the case if the Commissioner determines that the taxpayer's purpose with respect thereto was a purpose to avoid Federal income tax on the exchange or was not a bona fide business purpose, and the taxpayer contests such determination by litigation, the taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

§1.357-2 Liabilities in excess of basis.

(a) Section 357(c) provides in general that in an exchange to which section 351 (relating to a transfer to a corporation controlled by the transferor) is applicable, or to which section 361 (relating to the nonrecognition of gain or loss to corporations) is applicable by reason of a section 368(a)(1)(D) reorganization, if the sum of the amount of liabilities assumed plus the amount of liabilities to which the property is subject exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset as the case may be. Thus, if an individual transfers, under section 351, properties having a total basis in his hands of $20,000, one of which has a basis of $10,000 but is subject to a mortgage of $30,000, to a corporation controlled by him, such individual will be subject to tax with respect to $10,000, the excess of the amount of the liability over the total adjusted basis of all the properties in his hands. The same result will follow whether or not the liability is assumed by the transferee. The determination of whether a gain resulting from the transfer of capital assets is long-term or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred. An exception to the general rule of section 357(c) is made

(1) for any exchange as to which under section 357(b) (relating to assumption of liabilities for tax-avoidance purposes) the entire amount of the liabilities is treated as money received and

(2) for an exchange to which section 371 (relating to reorganizations in certain receivership and bankruptcy proceedings) or section 374 (relating to gain or loss not recognized in certain railroad reorganizations) is applicable.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1. If all such assets transferred are capital assets and if half the assets (ascertained by reference to their fair market value at the time of the transfer) have been held for less than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and the remaining half for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), half the excess of the amount of the liability over the total of the adjusted basis of the property transferred pursuant to the

exchange shall be treated as short-term capital gain, and the remaining half shall be treated as long-term capital gain.

Example 2. If half of the assets (ascertained by reference to their fair market value at the time of the transfer) transferred are capital assets and half are assets other than capital assets, then half of the excess of the amount of the liability over the total of the adjusted basis of the property transferred pursuant to the exchange shall be treated as capital gain, and the remaining half shall be treated as gain from the sale or exchange of assets other than capital assets.

§1.358-3 Treatment of assumption of liabilities.

(a) For purposes of section 358, where a party to the exchange assumes a liability of a distributee or acquires from him property subject to a liability, the amount of such liability is to be treated as money received by the distributee upon the exchange, whether or not the assumption of liabilities resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1.

A, an individual, owns property with an adjusted basis of $100,000 on which there is a purchase money mortgage of $25,000. On December 1, 1945, A organizes Corporation X to which he transfers the property in exchange for all the stock of Corporation X and the assumption by Corporation X of the mortgage. The capital stock of the Corporation X has a fair market value of $150,000. Under sections 351 and 357, no gain or loss is recognized to A. The basis in A's hands of the stock of Corporation X is $75,000, computed as follows:

Adjusted basis of property transferred	$100,000
Less: Amount of money received (amount of liabilities assumed)	—25,000
Basis of Corporation X stock to A	75,000

Example 2.

A, an individual, owns property with an adjusted basis of $25,000 on which there is a mortgage of $50,000. On December 1, 1954, A organizes Corporation X to which he transfers the property in exchange for all the stock of Corporation X and the assumption by Corporation X of the mortgage. The stock of Corporation X has a fair market value of $50,000. Under sections 351 and 357, gain is recognized to A in the amount of $25,000. The basis in A's hands of the stock of Corporation X is zero, computed as follows:

Adjusted basis of property transferred	$25,000
Less: Amount of money received (amount of liabilities)	—50,000
Plus: Amount of gain recognized to taxpayer	25,000
Basis of Corporation X stock to A	0

§1.362-4 Basis of loss duplication property.

(b) *Basis determinations under section 362(e)(2) and this section.* Notwithstanding section 362(a), if a corporation (Acquiring) receives loss duplication property (as defined in paragraph (g)(1) of this section) from a person (Transferor) in a loss duplication transaction (as defined in paragraph (g)(2) of this section), Acquiring's basis in such property is equal to the basis of the property determined without regard to section 362(e)(2) and this section (as described in paragraph (g)(1)(ii) of this section), reduced by the property's allocable portion of Transferor's net built-in loss (as defined in paragraph (g)(3) of this section). If more than one Transferor transfers property to a corporation in a section 362(a) transaction, whether and the extent to which section 362(e)(2) and this section apply is determined separately for each Transferor.

(g) *Definitions.* For purposes of section 362(e)(2) and this section—

(1) *Loss duplication property* is any property—

(i) That is transferred by Transferor to Acquiring in a loss duplication transaction (as defined in paragraph (g)(2) of this section); and

(ii) That Acquiring would take with a basis in excess of value immediately after the transaction; for this purpose, the basis Acquiring would take in the property is determined immediately after the transaction and without regard to section 362(e)(2) and this section, but otherwise taking into account all applicable provisions of law, including, without limitation, section 362(e)(1).

(2) A *loss duplication transaction* is a section 362(a) transaction in which Acquiring's aggregate basis in the property received from Transferor would, but for section 362(e)(2) and this section, exceed the aggregate value of such property immediately after the transaction. For this purpose—

(i) A transaction is a section 362(a) transaction if it is described in section 362(a) without regard to whether it is also described in any other provision of the Internal Revenue Code (Code), including, without limitation, section 362(b); and

(ii) Acquiring's aggregate basis in the property received from Transferor is determined immediately after the transaction and without regard to section 362(e)(2) and this section, but otherwise taking into account all applicable provisions of law, including, without limitation, section 362(e)(1).

(3) *Transferor's net built-in loss* is the excess of—

(i) Acquiring's aggregate basis (determined under paragraph (g)(2)(ii) of this section) in all property received from Transferor in a loss duplication transaction, over

(ii) The aggregate value of such property immediately after the transaction.

(4) A property's *built-in loss* is the excess of Acquiring's basis in the property (determined as described in paragraph (g)(1)(ii) of this section) over the property's value (determined immediately after the transaction).

(5) A property's *allocable portion of Transferor's net built-in loss* is the portion of Transferor's net built-in loss that bears the same ratio to Transferor's net built-in loss that the property's built-in loss bears to the aggregate built-in losses reflected in the bases of loss duplication property transferred by Transferor in the transaction.

(6) A *U.S. return* is a return of income under section 6012 or an information return under Subtitle F, Chapter 61, Subchapter A, Part III of the Code (sections 6031 and following) or the regulations thereunder, that the taxpayer is unconditionally required to file. Thus, the term does not include elective forms or statements that

are required to be filed only to obtain a particular tax treatment, including forms filed to make an election or to reduce or avoid withholding by a person not otherwise required to file a U.S. return (as described in this paragraph (g)(6)) (for example, a notice of nonrecognition under § 1.1445-2(d)).

(7) A *controlled foreign corporation* (CFC) is any corporation described in section 957 or section 953(c).

(8) A *controlling U.S. shareholder* is any person that is treated as a controlling U.S. shareholder under § 1.964-1(c)(5) because such person either owns a direct interest in the CFC or is treated as owning an interest in the CFC by reason of section 318(a)(2) (attribution from partnerships, estates, trusts, and corporations).

(9) A *controlled foreign partnership* (CFP) is any partnership treated as a controlled foreign partnership for purposes of section 6038.

(10) A *reporting U.S. partner* is any partner of a CFP that is required to file an information return with respect to the CFP pursuant to section 6038 or the regulations thereunder, without regard to § 1.6038-3(c) or (j). In addition, in applying the constructive ownership rules of § 1.6038-3(b)(4), the term "nonresident alien" is replaced by the term "individual."

(11) The term *stock* means both Acquiring stock and Acquiring securities received by Transferor in the transaction if gain or loss on the receipt of the stock or securities is not recognized in whole or in part.

(12) *Value* —

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

(ii) *Special rule for transfers of partnership interests.* Notwithstanding the general rule in paragraph (g)(12)(i) of this section, when referring to a partnership interest, for purposes of section 362(e)(2) and this section, the term *value* means the sum of the cash that Acquiring would receive for the interest, assuming an exchange between a willing buyer and a willing seller (neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts), increased by any § 1.752-1 liabilities (as defined in § 1.752-1(a)(4)) of the partnership allocated to Acquiring with regard to such transferred interest under section 752 immediately after the transfer to Acquiring. See § 1.743-1 regarding the application of section 743(b) following a section 362(e) basis reduction.

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

(c) *Scope.* The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 354(a)(1) in which stock or securities in a corporation, a party to a reorganization, are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation, a party to the same reorganization; and the exchange that is provided for in section 361(a) in which a corporation, a party to a reorganization, exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation, a party to the same reorganization. Section 368(a)(1) limits the definition of the term *reorganization* to six kinds of transactions and excludes all others. From its context, the term *a party to a reorganization* can only mean a party to a transaction specifically defined as a reorganization by section 368(a). Certain rules respecting boot received in either of the two types of exchanges provided for in section 354(a)(1) and section 361(a) are prescribed in sections 356, 357, and 361(b). A special rule respecting a transfer of property with a liability in excess of its basis is prescribed in section 357(c). Under section 367 a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope. The provisions of the Code referred to in this paragraph are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions

specifically described as a reorganization in section 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

(e) *Continuity of interest —*

(1) *General rule.*

(i) The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (as defined in paragraph (b) of this section), it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation. However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. See paragraph (e)(6) of this section for rules related to when a creditor's claim against a target corporation is a proprietary interest in the corporation. For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related (as defined in paragraph (e)(4) of this section determined without regard to paragraph (e)(4)(i)(A) of this section) to the target corporation or to persons not related (as defined in paragraph (e)(4) of this section) to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related (as defined in paragraph (e)(4) of this section) to the issuing corporation is disregarded.

(ii) For purposes of paragraph (e)(1)(i) of this section, a proprietary interest in the target corporation (other than one held by the acquiring corporation) is not preserved to the extent that consideration received prior to a potential reorganization, either in a redemption of the target corporation stock or in a distribution with respect to the target corporation stock, is treated as other property or money received in the exchange for purposes of section 356, or would be so treated if the target shareholder also had received stock of the issuing corporation in exchange for stock owned by the shareholder in the target corporation. A proprietary interest in the target corporation is not preserved to the extent that creditors (or former creditors) of the target corporation that own a proprietary interest in the corporation under paragraph (e)(6) of this section (or would be so treated if they had received the consideration in the potential reorganization) receive payment for the claim prior to the potential reorganization and such payment would be treated as other property or money received in the exchange for purposes of section 356 had it been a distribution with respect to stock.

(2) *Measuring continuity of interest —*

(i) *In general.* In determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization shall be valued on the last business day before the first date such

contract is a binding contract (the pre-signing date), if such contract provides for fixed consideration. If a portion of the consideration provided for in such a contract consists of other property identified by value, then this specified value of such other property is used for purposes of determining the extent to which a proprietary interest in the target corporation is preserved. If the contract does not provide for fixed consideration, this paragraph (e)(2)(i) is not applicable.

(ii) *Binding contract —*

(A) *In general.* A binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) shall not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, shall not prevent an instrument from being a binding contract.

(B) *Modifications —*

(*1*) *In general.* If a term of a binding contract that relates to the amount or type of the consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, the date of the modification shall be treated as the first date there is a binding contract.

(*2*) *Modification of a transaction that preserves continuity of interest.* Notwithstanding paragraph (e)(2)(ii)(B)(*1*) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if—

(*i*) The modification has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders;

(*ii*) The modification has the sole effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders; or

(*iii*) The modification has the effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders.

(*3*) *Modification of a transaction that does not preserve continuity of interest.* Notwithstanding paragraph (e)(2)(ii)(B)(*1*) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would not have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if—

(*i*) The modification has the sole effect of providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders;

(*ii*) The modification has the sole effect of increasing the amount of money or other property to be delivered to the target corporation shareholders; or

(*iii*) The modification has the effect of increasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders.

(C) *Tender offers.* For purposes of this paragraph (e)(2), a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 [15 U.S.C. 78n(d)(1)] and Regulation 14D (17 CFR 240.14d-1 through 240.14d-101) and is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees. If a modification (not pursuant to a binding contract) of such a tender offer is subject to the provisions of Regulation 14d-6(c) (17 CFR 240.14d-6(c)) and relates to the amount or type of the consideration received in the tender offer, then the date of the modification shall be treated as the first date there is a binding contract.

(iii) *Fixed consideration —*

(A) *In general.* A contract provides for fixed consideration if it provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation. A shareholder's election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination of stock of the issuing corporation, money, or other property) in exchange for all of the shareholder's proprietary interests in the target corporation, or each of the shareholder's proprietary interests in the target corporation, will not prevent a contract from satisfying the definition of fixed consideration provided for in this paragraph (e)(2)(iii)(A).

(B) *Shareholder elections.* A contract that provides a target corporation shareholder with an election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination of stock of the issuing corporation, money, or other property) in exchange for all of the shareholder's proprietary interests in the target corporation, or each of the shareholder's proprietary interests in the target corporation, provides for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is determined using the value of the issuing corporation stock on the last business day before the first date there is a binding contract. This is the case even though the shareholder election may preclude a determination, prior to the closing date, of the number of shares of each class of the issuing corporation, the amount of money, and the other property (or the combination of shares, money and other property) to be exchanged for each proprietary interest in the target corporation.

(C) *Contingent adjustments to the consideration —*

(*1*) *In general.* Except as provided in paragraph (e)(2)(iii)(C)(*2*) of this section, a contract that provides for contingent adjustments to the consideration will be treated as providing for fixed consideration if it would satisfy the requirements of paragraph (e)(2)(iii)(A) of this section without the contingent adjustment provision.

(*2*) *Exceptions.* A contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation stock after the last business day before the first date the contract is a binding contract. For example, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration in the event that the value of the stock of the issuing corporation, the value of the assets of the issuing corporation, or the value of any surrogate for

either the value of the stock of the issuing corporation or the assets of the issuing corporation increases or decreases after the last business day before the first date there is a binding contract. Similarly, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the number of shares of the issuing corporation stock to be provided to the target corporation shareholders computed using any value of the issuing corporation shares after the last business day before the first date there is a binding contract.

(D) *Escrows.* Placing part of the consideration to be exchanged for proprietary interests in the target corporation in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties will not prevent a contract from being treated as providing for fixed consideration.

(E) *Anti-dilution clauses.* The presence of a customary anti-dilution clause will not prevent a contract from being treated as providing for fixed consideration. However, the absence of such a clause will prevent a contract from being treated as providing for fixed consideration if the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the transaction and the effective date of the transaction in a manner that materially alters the economic arrangement of the parties to the binding contract. If the number of shares of the issuing corporation to be issued to the target corporation shareholders is altered pursuant to a customary anti-dilution clause, the value of the shares determined under paragraph (e)(2)(i) of this section must be adjusted accordingly.

(F) *Dissenters' rights.* The possibility that some shareholders may exercise dissenters' rights and receive consideration other than that provided for in the binding contract will not prevent the contract from being treated as providing for fixed consideration.

(G) *Fractional shares.* The fact that money may be paid in lieu of issuing fractional shares will not prevent a contract from being treated as providing for fixed consideration.

(iv) *New issuances.* For purposes of applying paragraph (e)(2)(i) of this section, any class of stock, securities, or indebtedness that the issuing corporation issues to the target corporation shareholders pursuant to the potential reorganization and that does not exist before the first date there is a binding contract to effect the potential reorganization is deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization.

(v) *Examples.* For purposes of the examples in this paragraph (e)(2)(v), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A is an individual, no transactions other than those described occur, and the transactions are not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e)(2):

Example 1. Application of signing date rule. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Twenty of the P shares, however, will be placed in escrow to secure customary target representations and warranties. The P stock is listed on an established market. On January 2 of year 1, the value of the P stock is $1 per share. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is $.25 per share. None of the stock placed in escrow is returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the

pre-signing date. Because, for continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 2. Treatment of forfeited escrowed stock.

(i) Escrowed stock. The facts are the same as in *Example 1* except that T's breach of a representation results in the escrowed consideration being returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Pursuant to paragraph (e)(1)(i) of this section, for continuity of interest purposes, the T stock is exchanged for $20 of P stock and $60 of cash, and the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

(ii) *Escrowed stock and cash.* The facts are the same as in paragraph (i) of this *Example 2* except that the consideration placed in escrow consists solely of eight of the P shares and $12 of the cash. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Pursuant to paragraph (e)(1)(i) of this section, for continuity of interest purposes, the T stock is exchanged for $32 of P stock and $48 of cash, and the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in *Example 1* except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and $30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for $1 per share. Shortly after the merger, S purchases A's P shares for $20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of this section. Accordingly, A is treated as exchanging his T shares for $50 of cash. Because, for continuity of interest purposes, the T stock is exchanged for $20 of P stock and $80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 4. Modification of binding contract—continuity not preserved. The facts are the same as in *Example 1* except that on April 1 of year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the T shareholders will receive 50 P shares (an additional 10 shares) and $75 of cash (an additional $15 of cash) in exchange for all of the outstanding T stock. On March 31 of year 1, the value of the P stock is $.50 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of year 1. The execution of the transaction without modification would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification. However, because the modified contract provides for additional P stock and cash to be exchanged for all the proprietary interests in T, the exception in paragraph (e)(2)(ii)(B)(*2*) of this section does not apply to preserve the original signing date. Therefore,

whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on March 31 of year 1. Because, for continuity of interest purposes, the T stock is exchanged for $25 of P stock and $75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 5. Modification of binding contract disregarded—continuity preserved. The facts are the same as in *Example 4* except that, pursuant to the modified contract, which is a binding contract, the T shareholders will receive 60 P shares (an additional 20 shares as compared to the original contract) and $60 of cash in exchange for all of the outstanding T stock. In addition, on March 31 of year 1, the value of the P stock is $.40 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of year 1. Nonetheless, the modification has the sole effect of providing for the issuance of additional P shares to the T shareholders. In addition, the execution of the terms of the contract without regard to the modification would have resulted in the preservation of a substantial part of the value of the T shareholders' proprietary interest in T because, for continuity of interest purposes, the T stock would have been exchanged for $40 of P stock and $60 of cash. Pursuant to paragraph (e)(2)(ii)(B)(*2*) of this section, the modification is not treated as a modification for purposes of paragraph (e)(2)(ii)(B)(*1*) of this section. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Because, for continuity of interest purposes, the T stock is exchanged for $60 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore the transaction satisfies the continuity of interest requirement.

Example 6. New issuance. The facts are the same as in *Example 1*, except that, instead of cash, the T shareholders will receive a new class of P securities that will be publicly traded. In the aggregate, the securities will have a stated principal amount of $60 and bear interest at the average LIBOR (London Interbank Offered Rates) during the 10 days prior to the potential reorganization. If the T shareholders had been issued the P securities on January 2 of year 1, the P securities would have had a value of $60 (determined by reference to the value of comparable publicly traded securities). Whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock and the P securities to be issued to the T shareholders on January 2 of year 1. Under paragraph (e)(2)(iv) of this section, for purposes of valuing the new P securities, they will be treated as having been issued on the pre-signing date. Because, for continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 of other property, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 7. Fixed consideration—continuity not preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. Pursuant to the contract, 60 shares of the T stock will be exchanged for $80 of cash and 40 shares of the T stock will be exchanged for 20 shares of P stock. On January 2 of year 1, the value of the P stock is $1 per share. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. This contract provides for fixed consideration and therefore whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. However, applying the signing date rule, the P stock represents only 20 percent of the value of the total consideration to be received by the T shareholders. Accordingly, based on the economic realities of the exchange, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 8. Anti-dilution clause.

(i) *Absence of anti-dilution clause.* On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. The contract does not contain a customary anti-dilution provision. The P stock is listed on an established market. On January 2 of year 1, the value of the P stock is $1 per share. On April 10 of year 1, P issues its stock to effect a stock split; each shareholder of P receives an additional share of P for each P share that it holds. On April 11 of year 1, the value of the P stock is $.50 per share. Because P altered its capital structure between January 3 and June 1 of year 1 in a manner that materially alters the economic arrangement of the parties, under paragraph (e)(2)(iii)(E) of this section, the contract is not treated as a binding contract that provides for fixed consideration. Accordingly, whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of year 1.

(ii) *Adjustment for anti-dilution clause.* The facts are the same as in paragraph (i) of this *Example 8* except that the contract contains a customary anti-dilution provision, and the T shareholders receive 80 P shares and $60 of cash in exchange for all of the outstanding stock of T. Under paragraph (e)(2)(iii)(E) of this section, the contract is treated as a binding contract that provides for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is generally determined by reference to the value of the P stock on January 2 of year 1. However, under paragraph (e)(2)(iii)(E) of this section, the value of the P stock on the pre-signing date must be adjusted to take the stock split into account. For continuity of interest purposes, the T stock is exchanged for $40 of P stock (($1/2) × 80) and $60 of cash. Therefore, the transaction satisfies the continuity of interest requirement.

Example 9. Shareholder election. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On January 2 of year 1, the value of the P stock and the T stock is $1 per share. Pursuant to the contract, at the shareholders' election, each share of T's 100 shares will be exchanged for cash of $1, or alternatively, P stock. The contract provides that the determination of the number of shares of P stock to be exchanged for a share of T stock is made using the value of the P stock on the last business day before the first date there is a binding contract (that is, $1 per share). The contract further provides that, in the aggregate, 40 shares of P stock and $60 will be delivered, and contains a proration mechanism in the event that either item of consideration is oversubscribed. On the closing date, the value of the P stock is $.20 per share, and all target shareholders elect to receive cash. Pursuant to the proration provision, each target share is exchanged for $.60 of cash and $.08 of P stock. Pursuant to paragraph (e)(2)(iii)(A) of this section, the contract provides for fixed consideration because it provides for the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in the target corporation. Furthermore, pursuant to paragraph (e)(2)(iii)(B) of this section, the contract provides for fixed consideration because the number of shares of issuing corporation stock to be provided to the target corporation shareholders is determined using the pre-signing date value of P stock. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of year 1. Because, for continuity purposes, the T stock is exchanged for $40 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 10. Contingent adjustment based on the value of the issuing corporation stock—continuity not preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On January 2 of year 1, the value of the P stock is $1 per share. Pursuant to the contract, if the value of the P stock does not decrease after January 2 of year 1, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $.16 of additional P shares and $.24 for every $.01 decrease in the value of one share of P stock after January 2 of year 1. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is $.40 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T

shareholders receive 24 more P shares ((60 × $.16)/$.40) and $14.40 more cash (60 × $.24) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 64 P shares and $74.40 of cash. Because the contract provides that additional P shares and cash will be delivered to the T shareholders if the value of the stock of P decreases after January 2 of year 1, under paragraph (e)(2)(iii)(C)(*2*) of this section, the contract is not treated as providing for fixed consideration, and therefore whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of year 1. For continuity of interest purposes, the T stock is exchanged for $25.60 of P stock (64 × $.40) and $74.40 of cash and the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 11. Contingent adjustment to boot based on the value of the target corporation stock—continuity not preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On January 2 of year 1, T has 100 shares outstanding, and each T share is worth $1. On January 2 of year 1, each P share is worth $1. Pursuant to the contract, if the value of the T stock does not increase after January 3 of year 1, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $1 of additional cash for every $.01 increase in the value of one share of T stock after January 3 of year 1. On June 1 of year 1, the value of the T stock is $1.40 per share and the value of the P stock is $.75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive $40 more cash (40 × $1) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 40 P shares and $100 of cash. Because the contract provides the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in T, and the contingent adjustment to the cash consideration is not based on changes in the value of the P stock, P assets, or any surrogate thereof, after January 2 of year 1, there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of year 1. For continuity of interest purposes, the T stock is exchanged for $40 of P stock (40 × $1) and $100 of cash. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 12. Contingent adjustment to stock based on the value of the target corporation stock—continuity preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On that date T has 100 shares outstanding, and each T share is worth $1. On January 2 of year 1, each P share is worth $1. Pursuant to the contract, if the value of the T stock does not decrease after January 3 of year 1, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $.40 less P stock and $.60 less cash for every $.01 decrease in the value of one share of T stock after January 3 of year 1. The contract also provides that the number of P shares by which the consideration will be reduced as a result of this adjustment will be determined based on the value of the P stock on January 2 of year 1. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the T stock is $.70 per share and the value of the P stock is $.75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 12 fewer P shares ((30 × $.40)/$1) and $18 less cash (30 × $.60) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 28 P shares and $42 of cash. Because the contract provides for the number of shares of P stock and the amount of money to be exchanged for all of the proprietary interests in T, the contract does not provide for contingent adjustments to the consideration based on a change in value of the P stock, P assets, or any surrogate thereof, after January 2 of year 1, and the adjustment to the number of P shares the T shareholders receive is determined based on the value of the P shares on January 2 of year 1, there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on

January 2 of year 1. For continuity of interest purposes, the T stock is exchanged for $28 of P stock (28 × $1) and $42 of cash. Accordingly, the transaction satisfies the continuity of interest requirement.

(3) *Related persons acquisitions.* A proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, a person related (as defined in paragraph (e)(4) of this section) to the issuing corporation acquires, for consideration other than stock of the issuing corporation, either a proprietary interest in the target corporation or stock of the issuing corporation that was furnished in exchange for a proprietary interest in the target corporation. The preceding sentence does not apply to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

(4) *Definition of related person —*

(i) *In general.* For purposes of this paragraph (e), two corporations are related persons if either—

(A) The corporations are members of the same affiliated group as defined in section 1504 (determined without regard to section 1504(b)); or

(B) A purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to § 1.1502-80(b)).

(ii) *Special rules.* The following rules apply solely for purposes of this paragraph (e)(4):

(A) A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of the stock involved.

(B) A corporation, other than the target corporation or a person related (as defined in paragraph (e)(4) of this section determined without regard to paragraph (e)(4)(i)(A) of this section) to the target corporation, will be treated as related to the issuing corporation if the relationship is created in connection with the potential reorganization.

(5) *Acquisitions by partnerships.* For purposes of this paragraph (e), each partner of a partnership will be treated as owning or acquiring any stock owned or acquired, as the case may be, by the partnership in accordance with that partner's interest in the partnership. If a partner is treated as acquiring any stock by reason of the application of this paragraph (e)(5), the partner is also treated as having furnished its share of any consideration furnished by the partnership to acquire the stock in accordance with that partner's interest in the partnership.

(6) *Creditors' claims as proprietary interests —*

(i) *In general.* A creditor's claim against a target corporation may be a proprietary interest in the target corporation if the target corporation is in a title 11 or similar case (as defined in section 368(a)(3)) or the amount of the target corporation's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization. In such cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, every claim of that class of creditors and every claim of all equal and junior classes of creditors (in addition to the claims of shareholders) is a proprietary interest in the target corporation immediately prior to the potential reorganization to the extent provided in paragraph (e)(6)(ii) of this section.

(ii) *Value of proprietary interest —*

(A) *Claims of most senior class of creditors receiving stock.* A claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class of creditors will be treated as a proprietary interest in accordance with the rules of this paragraph (e)(6)(ii). For a claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation, and a claim of any equal class of creditors, the value of the proprietary interest in the target corporation represented by the claim is determined by multiplying the fair market value of the claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the claims of those classes of creditors, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. If only one class (or one set of equal classes) of creditors receives stock, such class (or set of equal classes) is treated as the most senior class of creditors receiving stock. When only one class (or one set of equal classes) of creditors receives issuing corporation stock in exchange for a creditor's proprietary interest in the target corporation, such stock will be counted for measuring continuity of interest provided that the stock issued by the issuing corporation is not de minimis in relation to the total consideration received by the insolvent target corporation, its shareholders, and its creditors.

(B) *Claims of junior classes of creditor receiving stock.* The value of a proprietary interest in the target corporation held by a creditor whose claim is junior to the claims of other classes of target claims which are receiving proprietary interests in the issuing corporation is the fair market value of the junior creditor's claim.

(iii) *Bifurcated claims.* If a creditor's claim is bifurcated into a secured claim and an unsecured claim pursuant to an order in a title 11 or similar case (as defined in section 368(a)(3)) or pursuant to an agreement between the creditor and the debtor, the bifurcation of the claim and the allocation of consideration to each of the resulting claims will be respected in applying the rules of this paragraph (e)(6).

(iv) *Effect of treating creditors as proprietors.* The treatment of a creditor's claim as a proprietary interest in the target corporation shall not preclude treating shares of the target corporation as proprietary interests in the target corporation.

(7) *Successors and predecessors.* For purposes of this paragraph (e), any reference to the issuing corporation or the target corporation includes a reference to any successor or predecessor of such corporation, except that the target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation.

(8) *Examples.* For purposes of the examples in this paragraph (e)(7), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A and B are individuals, PRS is a partnership, all reorganization requirements other than the continuity of interest requirement are satisfied, and the transaction is not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e):

Example 1. Sale of stock to third party.

(i) *Sale of issuing corporation stock after merger.* A owns all of the stock of T. T merges into P. In the merger, A receives P stock having a fair market value of $50x and cash of $50x. Immediately after the merger, and pursuant to a preexisting binding contract, A sells all of the P stock received by A in the merger to B. Assume that there are no facts and circumstances indicating that the cash used by B to purchase A's P stock was in substance

exchanged by P for T stock. Under paragraphs (e)(1) and (3) of this section, the sale to B is disregarded because B is not a person related to P within the meaning of paragraph (e)(4) of this section. Thus, the transaction satisfies the continuity of interest requirement because 50 percent of A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

(ii) *Sale of target corporation stock before merger.* The facts are the same as paragraph (i) of this *Example 1,* except that B buys A's T stock prior to the merger of T into P and then exchanges the T stock for P stock having a fair market value of $50x and cash of $50x. The sale by A is disregarded. The continuity of interest requirement is satisfied because B's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A's T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X's ownership interest in P increases from 60 to 80 percent of the stock of P. X is not a person related to P under paragraph (e)(4)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(4)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

Example 3. Participation by issuing corporation in post-merger sale. A owns 80 percent of the T stock and none of the P stock, which is widely held. T merges into P. In the merger, A receives P stock. In addition, A obtains rights pursuant to an arrangement with P to have P register the P stock under the Securities Act of 1933, as amended. P registers A's stock, and A sells the stock shortly after the merger. No person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(4) of this section. Under paragraphs (e)(1) and (3) of this section, the sale of the P stock by A is disregarded because no person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(4) of this section. The transaction satisfies the continuity of interest requirement because A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 4. Redemptions and purchases by issuing corporation or related persons.

(i) *Redemption by issuing corporation.* A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(ii) *Purchase of target corporation stock by issuing corporation.* The facts are the same as paragraph (i) of this *Example 4,* except that, instead of P redeeming its stock, prior to and in connection with the merger of T into S, P purchases 90 percent of the T stock from A for cash. The continuity of interest requirement is not satisfied, because in connection with the merger, P acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section. However, see § 1.338-3(d) (which may change the result in this case by providing that, by virtue of section 338, continuity of interest is satisfied for certain parties after a qualified stock purchase).

(iii) *Purchase of issuing corporation stock by person related to issuing corporation.* The facts are the same as paragraph (i) of this *Example 4*, except that, instead of P redeeming its stock, S buys all of the P stock received by A in the merger for cash. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S acquired P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

Example 5. Redemption in substance by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives P stock. In connection with the merger, B buys all of the P stock received by A in the merger for cash. Shortly thereafter, in connection with the merger, P redeems the stock held by B for cash. Based on all the facts and circumstances, P in substance has exchanged solely cash for T stock in the merger. The continuity of interest requirement is not satisfied, because in substance P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

Example 6. Purchase of issuing corporation stock through partnership. A owns 100 percent of the stock of T and none of the stock of P. S is an 85 percent partner in PRS. The other 15 percent of PRS is owned by unrelated persons. T merges into P. In the merger, A receives P stock. In connection with the merger, PRS purchases all of the P stock received by A in the merger for cash. Under paragraph (e)(5) of this section, S, as an 85 percent partner of PRS, is treated as having acquired 85 percent of the P stock exchanged for A's T stock in the merger, and as having furnished 85 percent of the cash paid by PRS to acquire the P stock. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S is treated as acquiring 85 percent of the P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

Example 7. Exchange by acquiring corporation for direct interest. A owns 30 percent of the stock of T. P owns 70 percent of the stock of T, which was not acquired by P in connection with the acquisition of T's assets. T merges into P. A receives cash in the merger. The continuity of interest requirement is satisfied, because P's 70 percent proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise.

Example 8. Maintenance of direct or indirect interest in issuing corporation. X, a corporation, owns all of the stock of each of corporations P and Z. Z owns all of the stock of T. T merges into P. Z receives P stock in the merger. Immediately thereafter and in connection with the merger, Z distributes the P stock received in the merger to X. X is a person related to P under paragraph (e)(4)(i)(A) of this section. The continuity of interest requirement is satisfied, because X was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in P, preserving a substantial part of the value of the proprietary interest in T. See paragraph (e)(3) of this section.

Example 9. Preacquisition redemption by target corporation. T has two shareholders, A and B. P expresses an interest in acquiring the stock of T. A does not wish to own P stock. T redeems A's shares in T in exchange for cash. No funds have been or will be provided by P for this purpose. P subsequently acquires all the outstanding stock of T from B solely in exchange for voting stock of P. The cash received by A in the prereorganization redemption is not treated as other property or money under section 356, and would not be so treated even if A had received some stock of P in exchange for his T stock. The prereorganization redemption by T does not affect continuity of interest, because B's proprietary interest in T is unaffected, and the value of the proprietary interest in T is preserved.

Example 10. Creditors treated as owning a proprietary interest.

(i) *More than one class of creditor receives issuing corporation stock.* T has assets with a fair market value of $150x and liabilities of $200x. T has two classes of creditors: two senior creditors with claims of $25x each; and one junior creditor with a claim of $150x. T transfers all of its assets to P in exchange for $95x in cash and shares of P stock with a fair market value of $55x. Each T senior creditor receives $20x in cash and P stock with a fair market value of $5x in exchange for his claim. The T junior creditor receives $55x in cash and P stock with a fair market value of $45x in exchange for his claim. The T shareholders receive no consideration in exchange for their T stock. Under paragraph (e)(6) of this section, because the amount of T's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization, the claims of the creditors of T may be proprietary interests in T. Because the senior creditors receive proprietary interests in P in the transaction in exchange for their claims, their claims and the claim of the junior creditor and the T stock are treated as proprietary interests in T immediately prior to the transaction. Under paragraph (e)(6)(ii)(A) of this section, the value of the proprietary interest of each of the senior creditors' claims is $5x (the fair market value of the senior creditor's claim, $25x, multiplied by a fraction, the numerator of which is $10x, the fair market value of the proprietary interests in the issuing corporation, P, received in the aggregate in exchange for the claims of all the creditors in the senior class, and the denominator of which is $50x, the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in P) received in the aggregate in exchange for such claims). Accordingly, $5x of the stock that each of the senior creditors receives is counted in measuring continuity of interest. Under paragraph (e)(6)(ii)(B) of this section, the value of the junior creditor's proprietary interest in T immediately prior to the transaction is $100x, the value of his claim. Thus, the value of the creditors' proprietary interests in total is $110x and the creditors received $55x worth of P stock in total in exchange for their proprietary interests. Therefore, P acquired 50 percent of the value of the proprietary interests in T in exchange for P stock. Because a substantial part of the value of the proprietary interests in T is preserved, the continuity of interest requirement is satisfied.

(ii) *One class of creditor receives issuing corporation stock and cash in disproportionate amounts.* T has assets with a fair market value of $80x and liabilities of $200x. T has one class of creditor with two creditors, A and B, each having a claim of $100x. T transfers all of its assets to P for $60x in cash and shares of P stock with a fair market value of $20x. A receives $40x in cash in exchange for its claim. B receives $20x in cash and P stock with a fair market value of $20x in exchange for its claim. The T shareholders receive no consideration in exchange for their T stock. The P stock is not de minimis in relation to the total consideration received. Under paragraph (e)(6) of this section, because the amount of T's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization, the claims of the creditors of T may be proprietary interests in T. Because the creditors of T received proprietary interests in P in the transaction in exchange for their claims, their claims and the T stock are treated as proprietary interests in T immediately prior to the transaction. Under paragraph (e)(6)(ii)(A) of this section, the value of the proprietary interest of each of the senior creditors is $10x (the fair market value of a senior creditor's claim, $40x, multiplied by a fraction, the numerator of which is $20x, the fair market value of the proprietary interests in the issuing corporation, P, received in the aggregate in exchange for the claims of all the creditors in the class, and the denominator of which is $80x, the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in P) received in the aggregate in exchange for such claims). Accordingly, $10x of the cash that was received by A and $10x of the P stock that was received by B are counted in measuring continuity of interest. Thus, the value of the creditors' proprietary interests in total is $20x and the creditors received $10x worth of P stock in total in exchange for their proprietary interests. Therefore, P acquired 50 percent of the value of the proprietary interests in T in exchange for P stock. Because a substantial part of the value of the proprietary interests in T is preserved, the continuity of interest requirement is satisfied.

(9) *Effective/applicability dates —*

(i) *In general.* Paragraphs (e)(1) and (e)(3) through (e)(7) of this section apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. Paragraph (e)(1)(ii) of this section, however, applies to transactions occurring after August 30, 2000, unless the transaction occurs

pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. Taxpayers who entered into a binding agreement on or after January 28, 1998, and before August 30, 2000, may request a private letter ruling permitting them to apply the final regulations to their transaction. A private letter ruling will not be issued unless the taxpayer establishes to the satisfaction of the IRS that there is not a significant risk of different parties to the transaction taking inconsistent positions, for Federal tax purposes, with respect to the applicability of the final regulations to the transaction. The sixth sentence of paragraph (e)(1)(i) of this section, the last sentence of paragraph (e)(1)(ii) of this section, paragraph (e)(3) of this section, paragraph (e)(6) of this section, and *Example 10* of paragraph (e)(8) of this section apply to transactions occurring after December 12, 2008.

(ii) *COI measurement date.* Paragraph (e)(2) of this section applies to transactions occurring pursuant to binding contracts entered into after December 19, 2011. For transactions entered into after March 19, 2010, and occurring pursuant to binding contracts entered into on or before December 19, 2011, the parties to the transaction may elect to apply the provisions of § 1.368-1T as contained in 26 CFR, Part 1, §§ 1.301-1.400, revised as of April 1, 2009. However, the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, may not elect to apply the provisions of § 1.368-1T as contained in 26 CFR, Part 1, §§ 1.301-1.400, revised as of April 1, 2009, unless all such taxpayers elect to apply such provisions. This election requirement will be satisfied if none of the specified parties adopts inconsistent treatment. For transactions entered into on or before March 19, 2010, see § 1.368-1T as contained in 26 CFR, Part 1, §§ 1.301-1.400, revised as of April 1, 2009.

§1.368-2 Definition of terms.

(a) The application of the term *reorganization* is to be strictly limited to the specific transactions set forth in section 368(a). The term does not embrace the mere purchase by one corporation of the properties of another corporation. The preceding sentence applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange in which gain or loss is not recognized.

(b)

(1)

(i) *Definitions.* For purposes of this paragraph (b)(1), the following terms shall have the following meanings:

(A) *Disregarded entity.* A disregarded entity is a business entity (as defined in § 301.7701-2(a) of this chapter) that is disregarded as an entity separate from its owner for Federal income tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for Federal income tax purposes, a corporation (as defined in § 301.7701-2(b) of this chapter) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).

(B) *Combining entity.* A combining entity is a business entity that is a corporation (as defined in § 301.7701-2(b) of this chapter) that is not a disregarded entity.

(C) *Combining unit.* A combining unit is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for Federal income tax purposes.

(ii) *Statutory merger or consolidation generally.* For purposes of section 368(a)(1)(A), a statutory merger or consolidation is a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation, in which transaction, as a result of the operation of such statute or statutes, the following events occur simultaneously at the effective time of the transaction—

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and

(B) The combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of paragraph (b)(1)(ii)(A) of this section.

(iii) *Examples.* The following examples illustrate the rules of paragraph (b)(1) of this section. In each of the examples, except as otherwise provided, each of R, V, Y, and Z is a C corporation. X is a domestic limited liability company. Except as otherwise provided, X is wholly owned by Y and is disregarded as an entity separate from Y for Federal income tax purposes. The examples are as follows:

Example 1. Divisive transaction pursuant to a merger statute.

(i) *Facts.* Under State W law, Z transfers some of its assets and liabilities to Y, retains the remainder of its assets and liabilities, and remains in existence for Federal income tax purposes following the transaction. The transaction qualifies as a merger under State W corporate law.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of Y, the combining entity and sole member of the transferee unit. In addition, the transaction does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because the separate legal existence of Z does not cease for all purposes. Accordingly, the transaction does not qualify as a statutory merger or consolidation under section 368(a)(1)(A).

Example 2. Merger of a target corporation into a disregarded entity in exchange for stock of the owner.

(i) *Facts.* Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective

time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal income tax purposes, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 3. Merger of a target S corporation that owns a QSub into a disregarded entity.

(i) *Facts.* The facts are the same as in *Example 2,* except that Z is an S corporation and owns all of the stock of U, a QSub.

(ii) *Analysis.* The deemed formation by Z of U pursuant to § 1.1361-5(b)(1) (as a consequence of the termination of U's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of U to X, followed by X's transfer of these assets to U in exchange for stock of U. See § 1.1361-5(b)(3) *Example 9.* The transaction will, therefore, satisfy the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and U, the sole members of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal income tax purposes, and Z ceases its separate legal existence for all purposes. Moreover, the deemed transfer of the assets of U in exchange for U stock does not cause the transaction to fail to qualify as a statutory merger or consolidation. See § 368(a)(2)(C). Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 4. Triangular merger of a target corporation into a disregarded entity.

(i) *Facts.* The facts are the same as in *Example 2,* except that V owns 100 percent of the outstanding stock of Y and, in the merger of Z into X, the Z shareholders exchange their stock of Z for stock of V. In the transaction, Z transfers substantially all of its properties to X.

(ii) *Analysis.* The transaction is not prevented from qualifying as a statutory merger or consolidation under section 368(a)(1)(A), provided the requirements of section 368(a)(2)(D) are satisfied. Because the assets of X are treated for Federal income tax purposes as the assets of Y, Y will be treated as acquiring substantially all of the properties of Z in the merger for purposes of determining whether the merger satisfies the requirements of section 368(a)(2)(D). As a result, the Z shareholders that receive stock of V will be treated as receiving stock of a corporation that is in control of Y, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D). Accordingly, the merger will satisfy the requirements of section 368(a)(2)(D).

Example 5. Merger of a target corporation into a disregarded entity owned by a partnership.

(i) *Facts.* The facts are the same as in *Example 2,* except that Y is organized as a partnership under the laws of State W and is classified as a partnership for Federal income tax purposes.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section. All of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit because neither X nor Y qualifies as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 6. Merger of a disregarded entity into a corporation.

(i) *Facts.* Under State W law, X merges into Z. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of X (but not the assets and liabilities of Y other than those of X) become the assets and liabilities of Z and X's separate legal existence ceases for all purposes.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of a transferor unit do not become the assets and liabilities of one or more members of the transferee unit. The transaction also does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because X does not qualify as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 7. Merger of a corporation into a disregarded entity in exchange for interests in the disregarded entity.

(i) *Facts.* Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger of Z into X, the Z shareholders exchange their stock of Z for interests in X so that, immediately after the merger, X is not disregarded as an entity separate from Y for Federal income tax purposes. Following the merger, pursuant to § 301.7701-3(b)(1)(i) of this chapter, X is classified as a partnership for Federal income tax purposes.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because immediately after the merger X is not disregarded as an entity separate from Y and, consequently, all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 8. Merger transaction preceded by distribution.

(i) *Facts.* Z operates two unrelated businesses, Business P and Business Q, each of which represents 50 percent of the value of the assets of Z. Y desires to acquire and continue operating Business P, but does not want to acquire Business Q. Pursuant to a single plan, Z sells Business Q for cash to parties unrelated to Z and Y in a taxable transaction, and then distributes the proceeds of the sale pro rata to its shareholders. Then, pursuant to State W law, Z merges into Y. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z related to Business P become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their Z stock for Y stock.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 9. State law conversion of target corporation into a limited liability company.

(i) *Facts.* Y acquires the stock of V from the V shareholders in exchange for consideration that consists of 50 percent voting stock of Y and 50 percent cash. Immediately after the stock acquisition, V files the necessary documents to convert from a corporation to a limited liability company under State W law. Y's acquisition of the stock of V and the conversion of V to a limited liability company are steps in a single integrated acquisition by Y of the assets of V.

(ii) *Analysis.* The acquisition by Y of the assets of V does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because V, the combining entity of the transferor unit, does not cease its separate legal existence. Although V is an entity disregarded from its owner for Federal income tax purposes, it continues to exist as a juridical entity after the conversion. Accordingly, Y's acquisition of the assets of V does not qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 10. Dissolution of target corporation.

(i) *Facts.* Y acquires the stock of Z from the Z shareholders in exchange for consideration that consists of 50 percent voting stock of Y and 50 percent cash. Immediately after the stock acquisition, Z files a certificate of dissolution pursuant to State W law and commences winding up its activities. Under State W dissolution law, ownership and title to Z's assets does not automatically vest in Y upon dissolution. Instead, Z transfers assets to its creditors in satisfaction of its liabilities and transfers its remaining assets to Y in the liquidation stage of the dissolution. Y's acquisition of the stock of Z and the dissolution of Z are steps in a single integrated acquisition by Y of the assets of Z.

(ii) *Analysis.* The acquisition by Y of the assets of Z does not satisfy the requirements of paragraph (b)(1)(ii) of this section because Y does not acquire all of the assets of Z as a result of Z filing the certificate of dissolution or simultaneously with Z ceasing its separate legal existence. Instead, Y acquires the assets of Z by reason of Z's transfer of its assets to Y. Accordingly, Y's acquisition of the assets of Z does not qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 11. Merger of corporate partner into a partnership.

(i) *Facts.* Y owns an interest in X, an entity classified as a partnership for Federal income tax purposes, that represents a 60 percent capital and profits interest in X. Z owns an interest in X that represents a 40 percent capital and profits interest. Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z ceases its separate legal existence for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y. As a result of the merger, X becomes an entity that is disregarded as an entity separate from Y for Federal income tax purposes.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal income tax purposes immediately after the transaction, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 12. State law consolidation.

(i) *Facts.* Under State W law, Z and V consolidate. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and V become the assets and liabilities of Y, an entity that is created in the transaction, and the existence of Z and V continues in Y. In the consolidation, the Z shareholders and the V shareholders exchange their stock of Z and V, respectively, for stock of Y.

(ii) *Analysis.* With respect to each of Z and V, the transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and V, respectively,

each of which is the combining entity of a transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z and V each ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as the statutory merger or consolidation of each of Z and V into Y for purposes of section 368(a)(1)(A).

Example 13. Transaction effected pursuant to foreign statutes.

(i) *Facts.* Z and Y are entities organized under the laws of Country Q and classified as corporations for Federal income tax purposes. Z and Y combine. Pursuant to statutes of Country Q the following events occur simultaneously: all of the assets and liabilities of Z become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to statutes of Country Q and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 14. Foreign law amalgamation using parent stock.

(i) *Facts.* Z and V are entities organized under the laws of Country Q and classified as corporations for Federal income tax purposes. Z and V amalgamate. Pursuant to statutes of Country Q, the following events occur simultaneously: all the assets and liabilities of Z and V become the assets and liabilities of R, an entity that is created in the transaction and that is wholly owned by Y immediately after the transaction, and Z's and V's separate legal existences cease for all purposes. In the transaction, the Z and V shareholders exchange their Z and V stock, respectively, for stock of Y.

(ii) *Analysis.* With respect to each of Z and V, the transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to Country Q law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and V, respectively, each of which is the combining entity of a transferor unit, become the assets and liabilities of R, the combining entity and sole member of the transferee unit, with regard to each of the above transfers, and Z and V each ceases its separate legal existence for all purposes. Because Y is in control of R immediately after the transaction, the Z shareholders and the V shareholders will be treated as receiving stock of a corporation that is in control of R, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D). Accordingly, the transaction qualifies as the statutory merger or consolidation of each of Z and V into R, a corporation controlled by Y, and is a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D).

(v) *Effective date —*

(A) *In general.* This paragraph (b)(1) applies to transactions occurring on or after January 23, 2006. For rules regarding statutory mergers or consolidation occurring before January 23, 2006, see § 1.368-2T as contained in 26 CFR part 1, revised April 1, 2005, and § 1.368-2(b)(1) as in effect before January 24, 2003 (see 26 CFR part 1, revised April 1, 2002).

(B) *Transitional rule.* A taxpayer may elect to apply the provisions of § 1.368-2T(b) as contained in 26 CFR part 1, revised April 1, 2005 (the temporary regulations), instead of the provisions of this paragraph (b), to a transaction that occurs on or after January 23, 2006, pursuant to a written agreement which is (subject to customary conditions) binding on January 22, 2006, and at all times thereafter, or pursuant to a tender offer announced prior to January 23, 2006. However, the combining entity of the transferor unit,

the combining entity of the transferee unit, any controlling corporation of the combining entity of the transferee unit if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, may not elect to apply the provisions of the temporary regulations unless all such taxpayers elect to apply the provisions of the temporary regulations.

(2) In order for the transaction to qualify under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(D), one corporation (the acquiring corporation) must acquire substantially all of the properties of another corporation (the acquired corporation) partly or entirely in exchange for stock of a corporation which is in control of the acquiring corporation (the controlling corporation), provided that

(i) the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation, and

(ii) no stock of the acquiring corporation is used in the transaction. The foregoing test of whether the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation means that the general requirements of a reorganization under section 368(a)(1)(A) (such as a business purpose, continuity of business enterprise, and continuity of interest) must be met in addition to the special requirements of section 368(a)(2)(D). Under this test, it is not relevant whether the merger into the controlling corporation could have been effected pursuant to State or Federal corporation law. The term *substantially all* has the same meaning as it has in section 368(a)(1)(C). Although no stock of the acquiring corporation can be used in the transaction, there is no prohibition (other than the continuity of interest requirement) against using other property, such as cash or securities, of either the acquiring corporation or the parent or both. In addition, the controlling corporation may assume liabilities of the acquired corporation without disqualifying the transaction under section 368(a)(2(D), and for purposes of section 357(a) the controlling corporation is considered a party to the exchange. For example, if the controlling corporation agrees to substitute its stock for stock of the acquired corporation under an outstanding employee stock option agreement, this assumption of liability will not prevent the transaction from qualifying as a reorganization under section 368(a)(2)(D) and the assumption of liability is not treated as money or other property for purposes of section 361(b). Section 368(a)(2)(D) applies whether or not the controlling corporation (or the acquiring corporation) is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to merge directly into the controlling corporation. Section 368(a)(2)(D) applies only to statutory mergers occurring after October 22, 1968.

(3) For regulations under section 368(a)(2)(E), see paragraph (j) of this section.

(c) In order to qualify as a “reorganization” under section 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation (or, in the case of transactions occurring after December 31, 1963, solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, Corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of Corporation Y, the transaction is not a reorganization under section 368(a)(1)(B). Nor is a transaction a reorganization described in section 368(a)(1)(B) if stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation. The acquisition of stock of another corporation by the acquiring corporation solely for its voting stock (or solely for voting stock of a corporation which is in control of the acquiring corporation) is permitted tax-free even though the acquiring corporation already owns some of the stock of the other corporation. Such an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months. For example, Corporation A purchased 30 percent of the common stock of Corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, Corporation A offers to exchange its

own voting stock for all the stock of Corporation W tendered within 6 months from the date of the offer. Within the 6-months' period Corporation A acquires an additional 60 percent of stock of Corporation W solely for its own voting stock, so that it owns 90 percent of the stock of Corporation W. No gain or loss is recognized with respect to the exchanges of stock of Corporation A for stock of Corporation W. For this purpose, it is immaterial whether such exchanges occurred before Corporation A acquired control (80 percent) of Corporation W or after such control was acquired. If Corporation A had acquired 80 percent of the stock of Corporation W for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.

(d) In order to qualify as a reorganization under section 368(a)(1)(C), the transaction must be one described in subparagraph (1) or (2) of this paragraph:

(1) One corporation must acquire substantially all the properties of another corporation solely in exchange for all or a part of its own voting stock, or solely in exchange for all or a part of the voting stock of a corporation which is in control of the acquiring corporation. For example, Corporation P owns all the stock of Corporation A. All the properties of Corporation W are transferred to Corporation A either solely in exchange for voting stock of Corporation P or solely in exchange for less than 80 percent of the voting stock of Corporation A. Either of such transactions constitutes a reorganization under section 368(a)(1)(C). However, if the properties of Corporation W are acquired in exchange for voting stock of both Corporation P and Corporation A, the transaction will not constitute a reorganization under section 368(a)(1)(C). In determining whether the exchange meets the requirement of “solely for voting stock”, the assumption by the acquiring corporation of liabilities of the transferor corporation, or the fact that property acquired from the transferor corporation is subject to a liability, shall be disregarded. Though such an assumption does not prevent an exchange from being solely for voting stock for the purposes of the definition of a reorganization contained in section 368(a)(1)(C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 368(a)(1)(C) does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirement that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities.

(2) One corporation:

(i) Must acquire substantially all of the properties of another corporation in such manner that the acquisition would qualify under (1) above, but for the fact that the acquiring corporation exchanges money, or other property in addition to such voting stock, and

(ii) Must acquire solely for voting stock (either of the acquiring corporation or of a corporation which is in control of the acquiring corporation) properties of the other corporation having a fair market value which is at least 80 percent of the fair market value of all the properties of the other corporation.

(3) For the purposes of subparagraph (2)(ii) only, a liability assumed or to which the properties are subject is considered money paid for the properties. For example, Corporation A has properties with a fair market value of $100,000 and liabilities of $10,000. In exchange for these properties, Corporation Y transfers its own voting stock, assumes the $10,000 liabilities, and pays $8,000 in cash. The transaction is a reorganization even though a part of the properties of Corporation A is acquired for cash. On the other hand, if the properties of Corporation A worth $100,000, were subject to $50,000 in liabilities, an acquisition of all the properties, subject to the liabilities, for any consideration other than solely voting stock would not qualify as a reorganization under this section since the liabilities alone are in excess of 20 percent of the fair market value of the properties. If the transaction would qualify under either subparagraph (1) or (2) of this paragraph and also under section 368(a)(1)(D), such transaction shall not be treated as a reorganization under section 368 (a)(1)(C).

(4)

(i) For purposes of paragraphs (d)(1) and (2)(ii) of this section, prior ownership of stock of the target corporation by an acquiring corporation will not by itself prevent the solely for voting stock requirement of such paragraphs from being satisfied. In a transaction in which the acquiring corporation has prior ownership of stock of the target corporation, the requirement of paragraph (d)(2)(ii) of this section is satisfied only if the sum of the money or other property that is distributed in pursuance of the plan of reorganization to the shareholders of the target corporation other than the acquiring corporation and to the creditors of the target corporation pursuant to section 361(b)(3), and all of the liabilities of the target corporation assumed by the acquiring corporation (including liabilities to which the properties of the target corporation are subject), does not exceed 20 percent of the value of all of the properties of the target corporation. If, in connection with a potential acquisition by an acquiring corporation of substantially all of a target corporation's properties, the acquiring corporation acquires the target corporation's stock for consideration other than the acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties), whether from a shareholder of the target corporation or the target corporation itself, such consideration is treated, for purposes of paragraphs (d)(1) and (2) of this section, as money or other property exchanged by the acquiring corporation for the target corporation's properties. Accordingly, the transaction will not qualify under section 368(a)(1)(C) unless, treating such consideration as money or other property, the requirements of section 368(a)(2)(B) and paragraph (d)(2)(ii) of this section are met. The determination of whether there has been an acquisition in connection with a potential reorganization under section 368(a)(1)(C) of a target corporation's stock for consideration other than an acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties) will be made on the basis of all of the facts and circumstances.

(ii) The following examples illustrate the principles of this paragraph (d)(4):

Example 1. Corporation P (P) holds 60 percent of the Corporation T (T) stock that P purchased several years ago in an unrelated transaction. T has 100 shares of stock outstanding. The other 40 percent of the T stock is owned by Corporation X (X), an unrelated corporation. T has properties with a fair market value of $110 and liabilities of $10. T transfers all of its properties to P. In exchange, P assumes the $10 of liabilities, and transfers to T $30 of P voting stock and $10 of cash. T distributes the P voting stock and $10 of cash to X and liquidates. The transaction satisfies the solely for voting stock requirement of paragraph (d)(2)(ii) of this section because the sum of $10 of cash paid to X and the assumption by P of $10 of liabilities does not exceed 20% of the value of the properties of T.

Example 2. The facts are the same as in *Example 1* except that P purchased the 60 shares of T for $60 in cash in connection with the acquisition of T's assets. The transaction does not satisfy the solely for voting stock requirement of paragraph (d)(2)(ii) of this section because P is treated as having acquired all of the T assets for consideration consisting of $70 of cash, $10 of liability assumption and $30 of P voting stock, and the sum of $70 of cash and the assumption by P of $10 of liabilities exceeds 20% of the value of the properties of T.

(iii) This paragraph (d)(4) applies to transactions occurring after December 31, 1999, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter.

§1.537-1 Reasonable needs of the business.

(b) *Reasonable anticipated needs.*

(1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

§1.537-2 Grounds for accumulation of earnings and profits.

(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§ 1.537-1 and 1.537-3 are satisfied:

(1) To provide for bona fide expansion of business or replacement of plant;

(2) To acquire a business enterprise through purchasing stock or assets;

(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

(4) To provide necessary working capital for the business, such as, for the procurement of inventories;

(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or

(6) To provide for the payment of reasonably anticipated product liability losses, as defined in section 172(j), §§ 1.172-13(b)(1), and 1.537-1(f).

§1.1032-1 Disposition by a corporation of its own capital stock.

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§1.1361-1 S corporation defined.

(l) *Classes of stock —*

(1) *General rule.* A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

(2) *Determination of whether stock confers identical rights to distribution and liquidation proceeds —*

(i) *In general.* The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

(ii) *State law requirements for payment and withholding of income tax.* State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (l)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

(iii) *Buy-sell and redemption agreements —*

(A) *In general.* Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless—

(*1*) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and

(*2*) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights. For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

(B) *Exception for certain agreements.* Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of § 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

(C) *Safe harbors for determinations of book value.* A determination of book value will be respected if—

(*1*) The book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or

(*2*) The book value is used for any substantial nontax purpose.

(iv) *Distributions that take into account varying interests in stock during a taxable year.* A governing provision does not, within the meaning of paragraph (l)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

(v) *Special rule for section 338(h)(10) elections.* If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and § 1.338(h)(10)-1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

(vi) *Examples.* The application of paragraph (l)(2) of this section may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Determination of whether stock confers identical rights to distribution and liquidation proceeds.

(i) The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

(ii) The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S so that those rights are not identical. Accordingly, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock and does not qualify as a small business corporation.

Example 2. Distributions that differ in timing.

(i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Example 3. Treatment of excessive compensation.

(i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

Example 4. Agreement to pay fringe benefits.

(i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

Example 5. Below-market corporation-shareholder loan.

(i) E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which section 7872 applies. Under section 7872, E is deemed to receive a distribution with respect to S stock

by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E.

Example 6. Agreement to adjust distributions for state tax burdens.

(i) S, a corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax distributions.

(ii) The binding agreement relates to distribution or liquidation proceeds. The agreement is thus a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds so that those rights are not identical. Therefore, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock.

Example 7. State law requirements for payment and withholding of income tax.

(i) The law of State X requires corporations to pay state income taxes on behalf of nonresident shareholders. The law of State X does not require corporations to pay state income taxes on behalf of resident shareholders. S is incorporated in State X. S's resident shareholders have the right (for example, under the law of State X or pursuant to S's bylaws or a binding agreement) to distributions that take into account the payments S makes on behalf of its nonresident shareholders.

(ii) The payment by S of state income taxes on behalf of its nonresident shareholders are generally treated as constructive distributions to those shareholders. Because S's resident shareholders have the right to equal distributions, taking into account the constructive distributions to the nonresident shareholders, S's shares confer identical rights to distribution proceeds. Accordingly, under paragraph (l)(2)(ii) of this section, the state law requiring S to pay state income taxes on behalf of its nonresident shareholders is disregarded in determining whether S has more than one class of stock.

(iii) The same result would follow if the payments of state income taxes on behalf of nonresident shareholders are instead treated as advances to those shareholders and the governing provisions require the advances to be repaid or offset by reductions in distributions to those shareholders.

Example 8. Redemption agreements.

(i) F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment.

(ii) On these facts, under paragraph (l)(2)(iii)(B) of this section, the agreement is disregarded in determining whether all outstanding shares of S's stock confer identical rights to distribution and liquidation proceeds.

Example 9. Analysis of redemption agreements.

(i) J, K, and L are shareholders of S, a corporation. L is also an employee of S. L's shares were not issued to L in connection with the performance of services. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels.

(ii) Under paragraph (l)(2)(iii)(B) of this section, the portion of the agreement providing for redemption of L's stock on termination of employment is disregarded. Under paragraph (l)(2)(iii)(A), the portion of the agreement

providing for redemption of L's stock if S's sales fall below certain levels is disregarded unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(3) *Stock taken into account.* Except as provided in paragraphs (b) (3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (l)(1) of this section, to the rights conferred by the other outstanding shares of stock.

(4) *Other instruments, obligations, or arrangements treated as a second class of stock —*

(i) *In general.* Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (l) unless they are described in paragraph (l)(5) (ii) or (iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (l)(4)(iii) (B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (l)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (l)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (l).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles —*

(A) *In general.* Except as provided in paragraph (l)(4)(i) of this section, any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (l)(3) of this section), regardless of whether designated as debt, is treated as a second class of stock of the corporation—

(*1*) If the instrument, obligation, or arrangement constituters equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and

(*2*) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in paragraph (b)(1) of this section.

(B) *Safe harbor for certain short-term unwritten advances and proportionately held obligations —*

(*1*) *Short-term unwritten advances.* Unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock for that taxable year, even if the advances are considered equity under general principles of Federal tax law. The failure of an unwritten advance to meet this safe harbor will not result in a second class of stock unless the advance is considered equity under paragraph (l)(4)(ii)(A)(*1*) of this section and a principal purpose of the advance is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(*2*) *Proportionately-held obligations.* Obligations of the same class that are considered equity under general principles of Federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. The obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(iii) *Certain call options, warrants or similar instruments —*

(A) *In general.* Except as otherwise provided in this paragraph (l)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

(B) *Certain exceptions.*

(*1*) A call option is not treated as a second class of stock for purposes of this paragraph (l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This paragraph (l)(4)(iii)(B)(*1*) continues to apply if the call option is transferred with the loan (or if a portion of the call option is transferred with a corresponding portion of the loan). However, if the call option is transferred without a corresponding portion of the loan, this paragraph (l)(4)(iii)(B)(*1*) ceases to apply. Upon that transfer, the call option is tested under paragraph (l)(4)(iii)(A) (notwithstanding anything in that paragraph to the contrary) if, but for this paragraph, the call option would have been treated as a second class of stock on the date it was issued.

(*2*) A call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (l) if—

(*i*) The call option is nontransferable within the meaning of § 1.83-3(d); and

(*ii*) The call option does not have a readily ascertainable fair market value as defined in § 1.83-7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (l)(4)(iii)(B)(*2*) ceases to apply. Solely for purposes of this paragraph (l)(4)(iii)(B)(*2*), a corporation is related to the issuing corporation if more than 50 percent of the total voting power and total value of its stock is owned by the issuing corporation.

(*3*) The Commissioner may provide other exceptions by Revenue Ruling or other published guidance.

(C) *Safe harbor for certain options.* A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

(iv) *Convertible debt.* A convertible debt instrument is considered a second class of stock if—

(A) It would be treated as a second class of stock under paragraph (l)(4)(ii) of this section (relating to instruments, obligations, or arrangements treated as equity under general principles); or

(B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under paragraph (l)(4)(iii) of this section (relating to certain call options, warrants, and similar instruments).

(v) *Examples.* The application of this paragraph (l)(4) may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Transfer of call option by eligible shareholder to ineligible shareholder.

(i) S, a corporation, has 10 shareholders. S issues call options to A, B, and C, individuals who are U.S. residents. A, B, and C are not shareholders, employees, or independent contractors of S. The options have a strike price of $40 and are issued on a date when the fair market value of S stock is also $40. A year later, P, a partnership, purchases A's option. On the date of transfer, the fair market value of S stock is $80.

(ii) On the date the call option is issued, its strike price is not substantially below the fair market value of the S stock. Under paragraph (l)(4)(iii)(A) of this section, whether a call option is a second class of stock must be redetermined if the call option is transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section. In this case, A is an eligible shareholder of S under paragraph (b)(1) of this section, but P is not. Accordingly, the option is retested on the date it is transferred to D.

(iii) Because on the date the call option is transferred to P its strike price is 50% of the fair market value, the strike price is substantially below the fair market value of the S stock. Accordingly, the call option is treated as a second class of stock as of the date it is transferred to P if, at that time, it is determined that the option is substantially certain to be exercised. The determination of whether the option is substantially certain to be exercised is made on the basis of all the facts and circumstances.

Example 2. Call option issued in connection with the performance of services.

(i) E is a bona fide employee of S, a corporation. S issues to E a call option in connection with E's performance of services. At the time the call option is issued, it is not transferable and does not have a readily ascertainable fair market value. However, the call option becomes transferable before it is exercised by E.

(ii) While the option is not transferable, under paragraph (l)(4)(iii)(B)(*2*) of this section, it is not treated as a second class of stock, regardless of its strike price. When the option becomes transferable, that paragraph ceases to apply, and the general rule of paragraph (l)(4)(iii)(A) of this section applies. Accordingly, if the option is materially modified or is transferred to a person who is not an eligible shareholder under paragraph (b)(1) of this section, and on the date of such modification or transfer, the option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, the option is treated as a second class of stock.

(iii) If E left S's employment before the option became transferable, the exception provided by paragraph (l)(4)(iii)(B)(*2*) would continue to apply until the option became transferable.

(5) *Straight debt safe harbor —*

(i) *In general.* Notwithstanding paragraph (l)(4) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

(ii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

(iii) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section, but that is

considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361-1(l) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, § 1.1361-1(l) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992, and not materially modified after that date. In addition, a corporation and its shareholders may apply this § 1.1361-1(l) to prior taxable years.

§1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) *In general —*

(1) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under § 1.1366-1(a) (2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(4)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraphs (a)(2) and (a)(4)(ii) of this section).

(2) *Basis of indebtedness —*

(i) *In general.* The term *basis of any indebtedness of the S corporation to the shareholder* means the shareholder's adjusted basis (as defined in § 1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

(ii) *Special rule for guarantees.* A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.

(iii) *Examples.* The following examples illustrate the provisions of paragraph (a)(2)(i) and (ii) of this section:

Example 1. Shareholder loan transaction. A is the sole shareholder of S, an S corporation. S received a loan from A. Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness under paragraph (a)(2)(i) of this section. The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under § 301.7701-3 of this chapter.

Example 2. Back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 3. Loan restructuring through distributions. A is the sole shareholder of two S corporations, S1 and S2. In May 2014, S1 made a loan to S2. In December 2014, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 4. Guarantee. A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

(3) *Carryover of disallowance.* A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(4) (i) and (ii) of this section.

(4) *Basis limitation amount —*

(i) *Stock portion.* A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (3) of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2) (A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2) (B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under § 1.1367-1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2) (D) and (E). This

basis limitation amount for stock is determined at the time prescribed under § 1.1367-1(d)(1) for adjustments to the basis of stock.

(ii) *Indebtedness portion.* A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (3) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time prescribed under § 1.1367-2(d)(1) for adjustments to the basis of indebtedness.

(5) *Limitation on losses and deductions allocated to each item.* If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in § 1.1366-1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(4)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(4)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(6) *Nontransferability of losses and deductions —*

(i) *In general.* Except as provided in paragraph (a)(6)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(ii) *Exceptions for transfers of stock under section 1041(a).* If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) of this section for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(5) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock and the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii) *Examples.* The following examples illustrates the provisions of paragraph (a)(6)(ii) of this section:

Example 1. A owns all 100 shares in *X*, a calendar year S corporation. For *X*'s taxable year ending December 31, 2006, *A* has zero basis in the shares and *X* does not have any indebtedness to *A.* For the 2006 taxable year, *X* had $100 in losses that *A* cannot use because of the basis limitation in section 1366(d)(1) and that are treated as incurred by the corporation with respect to *A* in the following taxable year. Halfway through the 2007 taxable year, *A* transfers 50 shares to *B, A*'s former spouse in a transfer

to which section 1041(a) applies. In the 2007 taxable year, *X* has $80 in losses. On *A*'s 2007 individual income tax return, *A* may use the entire $100 carryover loss from 2006, as well as *A*'s share of the $80 2007 loss determined under section 1377(a) ($60), assuming A acquires sufficient basis in the *X* stock. On *B*'s 2007 individual income tax return, *B* may use *B*'s share of the $80 2007 loss determined under section 1377(a) ($20), assuming *B* has sufficient basis in the *X* stock. If any disallowed 2006 loss is disallowed to *A* under section 1366(d)(1) in 2007, that loss is prorated between *A* and *B* based on their stock ownership at the beginning of 2008. On *B*'s 2008 individual income tax return, *B* may use that loss, assuming *B* acquires sufficient basis in the *X* stock. If neither *A* nor *B* acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to *A* and $50 of loss with respect to *B* for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to *A* and $20 with respect to *B* for the $80 of disallowed 2007 loss.

Example 2. Assume the same facts as *Example 1*, except that during the 2007 taxable year, *A* acquires $10 of basis in *A*'s shares in *X*. For the 2007 taxable year, *A* may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of *A*'s 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to *A* and half of that loss with respect to *B* for the remaining $93.75 of disallowed 2006 loss, and if *B* does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to *A* and $20 with respect to *B* for the remaining disallowed 2007 loss.

(7) *Basis of stock acquired by gift.* For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (3) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

§301.7701-1 Classification of organizations for federal tax purposes.

(a) *Organizations for federal tax purposes —*

(1) *In general.* The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) *Certain joint undertakings give rise to entities for federal tax purposes.* A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co- owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(3) *Certain local law entities not recognized.* An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under

section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. 503, are not recognized as separate entities for federal tax purposes.

(4) *Single owner organizations.* Under §§ 301.7701-2 and 301.7701-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

§301.7701-2 Business entities; definitions.

(a) *Business entities.* For purposes of this section and § 301.7701-3, a *business entity* is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. But see paragraphs (c)(2)(iii) through (vii) of this section for special rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

(b) *Corporations.* For federal tax purposes, the term *corporation* means—

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under § 301.7701-3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 *et seq.*, or a similar federal statute;

(6) A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in § 1.892-2T;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

(8) *Certain foreign entities* —

(i) *In general.* Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation

Argentina, Sociedad Anonima

Australia, Public Limited Company

Austria, Aktiengesellschaft

Barbados, Limited Company

Belgium, Societe Anonyme

Belize, Public Limited Company

Bolivia, Sociedad Anonima

Brazil, Sociedade Anonima

Bulgaria, Aktsionerno Druzhestvo.

Canada, Corporation and Company

Chile, Sociedad Anonima

People's Republic of China, Gufen Youxian Gongsi

Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu

Colombia, Sociedad Anonima

Costa Rica, Sociedad Anonima

Cyprus, Public Limited Company

Czech Republic, Akciova Spolecnost

Denmark, Aktieselskab

Ecuador, Sociedad Anonima or Compania Anonima

Egypt, Sharikat Al-Mossahamah

El Salvador, Sociedad Anonima

Estonia, Aktsiaselts

European Economic Area/European Union, Societas Europaea

Finland, Julkinen Osakeyhtio/Publikt Aktiebolag

France, Societe Anonyme

Germany, Aktiengesellschaft

Greece, Anonymos Etairia

Guam, Corporation

Guatemala, Sociedad Anonima

Guyana, Public Limited Company

Honduras, Sociedad Anonima

Hong Kong, Public Limited Company

Hungary, Reszvenytarsasag

Iceland, Hlutafelag

India, Public Limited Company

Indonesia, Perseroan Terbuka

Ireland, Public Limited Company

Israel, Public Limited Company

Italy, Societa per Azioni

Jamaica, Public Limited Company

Japan, Kabushiki Kaisha

Kazakstan, Ashyk Aktsionerlik Kogham

Republic of Korea, Chusik Hoesa

Latvia, Akciju Sabiedriba

Liberia, Corporation

Liechtenstein, Aktiengesellschaft

Lithuania, Akcine Bendroves

Luxembourg, Societe Anonyme

Malaysia, Berhad

Malta, Public Limited Company

Mexico, Sociedad Anonima

Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap

New Zealand, Limited Company

Nicaragua, Compania Anonima

Nigeria, Public Limited Company

Northern Mariana Islands, Corporation

Norway, Allment Aksjeselskap

Pakistan, Public Limited Company

Panama, Sociedad Anonima

Paraguay, Sociedad Anonima

Peru, Sociedad Anonima

Philippines, Stock Corporation

Poland, Spolka Akcyjna

Portugal, Sociedade Anonima

Puerto Rico, Corporation

Romania, Societate pe Actiuni

Russia, Otkrytoye Aktsionernoy Obshchestvo

Saudi Arabia, Sharikat Al-Mossahamah

Singapore, Public Limited Company

Slovak Republic, Akciova Spolocnost

Slovenia, Delniska Druzba

South Africa, Public Limited Company

Spain, Sociedad Anonima

Surinam, Naamloze Vennootschap

Sweden, Publika Aktiebolag

Switzerland, Aktiengesellschaft

Thailand, Borisat Chamkad (Mahachon)

Trinidad and Tobago, Limited Company

Tunisia, Societe Anonyme

Turkey, Anonim Sirket

Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu

United Kingdom, Public Limited Company

United States Virgin Islands, Corporation

Uruguay, Sociedad Anonima

Venezuela, Sociedad Anonima or Compania Anonima

(ii) *Clarification of list of corporations in paragraph (b)(8)(i) of this section —*

(A) *Exceptions in certain cases.* The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(*1*) With regard to Canada, a Nova Scotia Unlimited Liability Company (or any other company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law).

(*2*) With regard to India, a company deemed to be a public limited company solely by operation of section 43A(1) (relating to corporate ownership of the company), section 43A(1A) (relating to annual average turnover), or section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of section 3(1)(iii) of the Companies Act, 1956.

(*3*) With regard to Malaysia, a Sendirian Berhad.

(B) *Inclusions in certain cases.* With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(iii) *Public companies.* For purposes of paragraph (b)(8)(i) of this section, with regard to Cyprus, Hong Kong, and Jamaica, the term Public Limited Company includes any Limited Company that is not defined as a private company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(iv) *Limited companies.* For purposes of this paragraph (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

(v) *Multilingual countries.* Different linguistic renderings of the name of an entity listed in paragraph (b)(8)(i) of this section shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(c) *Other business entities.* For federal tax purposes—

(1) The term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) *Wholly owned entities —*

(i) *In general.* Except as otherwise provided in this paragraph (c), a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

(ii) *Special rule for certain business entities.* If the single owner of a business entity is a bank (as defined in section 581, or, in the case of a foreign bank, as defined in section 585(a)(2)(B) without regard to the second sentence thereof), then the special rules applicable to banks under the Internal Revenue Code will continue to apply to the single owner as if the wholly owned entity were a separate entity. For this purpose, the special rules applicable to banks under the Internal Revenue Code do not include the rules under sections 864(c), 882(c), and 884.

(iii) *Tax liabilities of certain disregarded entities —*

(A) *In general.* An entity that is disregarded as separate from its owner for any purpose under this section is treated as an entity separate from its owner for purposes of—

(*1*) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded;

(*2*) Federal tax liabilities of any other entity for which the entity is liable; and

(*3*) Refunds or credits of Federal tax.

(B) *Examples.* The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:

Example 1. In 2006, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2005. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2009, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2005 taxable year. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in *Example 1,* except that in 2007, the IRS determines that X miscalculated and underreported its income tax liability for 2005. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

(iv) *Special rule for employment tax purposes —*

(A) *In general.* Except as provided in paragraph (c)(2)(iv)(C) of this section, paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(B) *Treatment of entity.* Except as provided in paragraph (c)(2)(iv)(C) of this section, an entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as a corporation with respect to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code). For special rules regarding the application of certain employment tax exceptions, see §§ 31.3121(b)(3)-1(d), 31.3127-1(b), and 31.3306(c)(5)-1(d) of this chapter.

(C) *Special rules.*

(*1*) Paragraphs (c)(2)(iv)(A) and (B) of this section do not apply to withholding requirements imposed by section 3406 (backup withholding). Thus, in the case of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the owner is subject to the withholding requirements imposed by section 3406 (backup withholding).

(*2*) Paragraph (c)(2)(i) of this section applies to taxes imposed under subtitle A of the Code, including Chapter 2—Tax on Self-Employment Income. Thus, an entity that is treated in the same manner as a sole proprietorship under paragraph (a) of this section is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity's activities. Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under this section is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under this section.

(D) *Example.* The following example illustrates the application of paragraph (c)(2)(iv) of this section:

Example.

(i) LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for Federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code. LLCA has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).

(ii) LLCA is subject to the provisions of subtitle C of the Internal Revenue Code and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, LLCA is required to perform such acts as are required of an employer under those provisions of the Internal Revenue Code and regulations thereunder that apply. All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts are applicable to LLCA. Thus, for example, LLCA is liable for income tax withholding, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. See sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, LLCA must file under its name and EIN the applicable Forms in the 94X series, for example, Form 941, “Employer's Quarterly Employment Tax Return,” Form 940, “Employer's Annual Federal Unemployment Tax Return;” file with the Social Security Administration and furnish to LLCA's employees statements on Forms W-2, “Wage and Tax Statement;” and make timely employment tax deposits. See §§ 31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1 of this chapter.

(iii) A is self-employed for purposes of subtitle A, chapter 2, Tax on Self-Employment Income, of the Internal Revenue Code. Thus, A is subject to tax under section 1401 on A's net earnings from self-employment with respect to LLCA's activities. A is not an employee of LLCA for purposes of subtitle C of the Internal Revenue Code. Because LLCA is treated as a sole proprietorship of A for income tax purposes, A is entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through LLCA, including the employer's share of employment taxes imposed under sections 3111 and 3301, on A's Form 1040, Schedule C, “Profit or Loss for Business (Sole Proprietorship).”

(v) *Special rule for certain excise tax purposes —*

(A) *In general.* Paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply for purposes of—

(*1*) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(*2*) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;

(*3*) Registration under sections 4101, 4222, 4412;

(*4*) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (c)(2)(v)(A)(*1*) of this section or under section 6426 or 6427; and

(*5*) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.

(B) *Treatment of entity.* An entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as a corporation with respect to items described in paragraph (c)(2)(v)(A) of this section.

(C) *Example.* The following example illustrates the provisions of this paragraph (c)(2)(v):

Example.

(i) LLCB is an eligible entity that has a single owner, B. LLCB is generally disregarded as an entity separate from its owner. However, under paragraph (c)(2)(v) of this section, LLCB is treated as an entity separate from its owner for certain purposes relating to excise taxes.

(ii) LLCB mines coal from a coal mine located in the United States. Section 4121 of chapter 32 of the Internal Revenue Code imposes a tax on the producer's sale of such coal. Section 48.4121-1(a) of this chapter defines a “producer” generally as the person in whom is vested ownership of the coal under state law immediately after the coal is severed from the ground. LLCB is the person that owns the coal under state law immediately after it is severed from the ground. Under paragraph (c)(2)(v)(A)(*1*) of this section, LLCB is the producer of the coal and is liable for tax on its sale of such coal under chapter 32 of the Internal Revenue Code. LLCB must report and pay tax on Form 720, “Quarterly Federal Excise Tax Return,” under its own name and taxpayer identification number.

(iii) LLCB uses undyed diesel fuel in an earthmover that is not registered or required to be registered for highway use. Such use is an off-highway business use of the fuel. Under section 6427(l), the ultimate purchaser is allowed to claim an income tax credit or payment related to the tax imposed on diesel fuel used in an off-highway

business use. Under paragraph (c)(2)(v) of this section, for purposes of the credit or payment allowed under section 6427(l), LLCB is the person that could claim the amount on its Form 720 or on a Form 8849, "Claim for Refund of Excise Taxes." Alternatively, if LLCB did not claim a payment during the time prescribed in section 6427(i)(2) for making a claim under section 6427, § 1.34-1 of this chapter provides that B, the owner of LLCB, could claim the income tax credit allowed under section 34 for the nontaxable use of diesel fuel by LLCB.

(iv) Assume the same facts as in paragraph (c)(2)(v)(C) *Example* (i) and (ii) of this section. If LLCB does not pay the tax on its sale of coal under chapter 32 of the Internal Revenue Code, any notice of lien the Internal Revenue Service files will be filed as if LLCB were a corporation.

(vi) *Special rule for reporting under section 6038A —*

(A) *In general.* An entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as an entity separate from its owner and classified as a corporation for purposes of section 6038A if—

(*1*) The entity is a domestic entity; and

(*2*) One foreign person has direct or indirect sole ownership of the entity.

(B) *Definitions —*

(*1*) *Indirect sole ownership.* For purposes of paragraph (c)(2)(vi)(A)(*2*) of this section, indirect sole ownership means ownership by one person entirely through one or more other entities disregarded as entities separate from their owners or through one or more grantor trusts, regardless of whether any such disregarded entity or grantor trust is domestic or foreign.

(*2*) *Entity disregarded as separate from its owner.* For purposes of paragraph (c)(2)(vi)(B)(*1*) of this section, an entity disregarded as an entity separate from its owner is an entity described in paragraph (c)(2)(i) of this section.

(*3*) *Grantor trust.* For purposes of paragraph (c)(2)(vi)(B)(*1*) of this section, a grantor trust is any portion of a trust that is treated as owned by the grantor or another person under subpart E of subchapter J of chapter 1 of the Code.

(C) *Taxable year.* The taxable year of an entity classified as a corporation for section 6038A purposes pursuant to paragraph (c)(2)(vi)(A) of this section is—

(*1*) The same as the taxable year of the foreign person described in paragraph (c)(2)(vi)(A)(*2*) of this section, if that foreign person has a U.S. income tax or information return filing obligation for its taxable year; or

(*2*) The calendar year, if paragraph (c)(2)(vi)(C)(*1*) of this section does not apply, unless otherwise provided in forms, instructions, or published guidance.

(vii) *Special rules for certain disregarded payments —*

(A) *Disregarded payment loss rules.* To the extent provided in § 1.1503(d)-1(d) of this chapter, certain payments involving a business entity that, under paragraph (c)(2)(i) of this section is otherwise disregarded as an entity separate from its owner, are in effect taken into account as if the entity were

regarded and the deduction was denied, and therefore give rise to an income inclusion, and corresponding suspended deduction, to the entity's owner.

(B) *Non-application of the sixty-month limitation.* If an eligible entity that is disregarded as an entity separate from its owner would become a disregarded payment entity (within the meaning of § 1.1503(d)-1(d)(5)(i)(A) of this chapter) when this paragraph (c)(2)(vii) applies, the sixty-month limitation under § 301.7701-3(c)(1)(iv) does not apply with respect to an election by such eligible entity to change its classification to an association effective before January 1, 2026 (such that it would not become a disregarded payment entity).

§301.7701-3 Classification of certain business entities.

(a) *In general.* A business entity that is not classified as a corporation under § 301.7701-2(b) (1), (3), (4), (5), (6), (7), or (8) (an *eligible entity*) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections, including a rule under which a domestic eligible entity that elects to be classified as an association consents to be subject to the dual consolidated loss rules of section 1503(d). Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) *Classification of eligible entities that do not file an election —*

(1) *Domestic eligible entities.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is—

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) *Foreign eligible entities —*

(i) *In general.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is—

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) *Definition of limited liability.* For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

(3) *Existing eligible entities —*

(i) *In general.* Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under §§ 301.7701-1 through 301.7701-3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities prior to the effective date of this section, see paragraph (h)(2) of this section.

(ii) *Special rules.* For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

(c) *Elections —*

(1) *Time and place for filing —*

(i) *In general.* Except as provided in paragraphs (c)(1) (iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See § 301.6109-1 for rules on applying for and displaying Employer Identification Numbers.

(ii) *Further notification of elections.* An eligible entity required to file a Federal tax or information return for the taxable year for which an election is made under § 301.7701-3(c)(1)(i) must attach a copy of its Form 8832 to its Federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 (“Entity Classification Election”) must be attached to the Federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under § 301.7701-3(c)(1)(i) will not be invalidated, but the non-filing party may be subject to penalties, including

any applicable penalties if the Federal tax or information returns are inconsistent with the entity's election under § 301.7701-3(c)(1)(i). In the case of returns for taxable years beginning after December 31, 2002, the copy of Form 8832 attached to a return pursuant to this paragraph (c)(1)(ii) is not required to be a signed copy.

(iii) *Effective date of election.* An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

(iv) *Limitation.* If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election. An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

(v) *Deemed elections —*

(A) *Exempt organizations.* An eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

(B) *Real estate investment trusts.* An eligible entity that files an election under section 856(c)(1) to be treated as a real estate investment trust is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day the entity is treated as a real estate investment trust.

(C) *S corporations.* An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under § 301.7701-3(c)(1)(i), to be classified as other than an association.

(vi) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1. On July 1, 1998, X, a domestic corporation, purchases a 10% interest in Y, an eligible entity formed under Country A law in 1990. The entity's classification was not relevant to any person for federal tax or information purposes prior to X's acquisition of an interest in Y. Thus, Y is not considered to be in existence on the effective date of this section for purposes of paragraph (b)(3) of this section. Under the applicable Country A statute, all members of Y have limited liability as defined in paragraph (b)(2)(ii) of this section. Accordingly, Y is classified as an association under paragraph (b)(2)(i)(B) of this section unless it elects under this paragraph (c) to be classified as a partnership. To be classified as a partnership as of July 1, 1998, Y must file a Form 8832 by September 14, 1998. See paragraph (c)(1)(i) of this section. Because an election cannot be effective more than 75 days prior to the date on which it is filed, if Y files its Form 8832 after September 14, 1998, it will be classified as an association from July 1, 1998, until the effective date of the election. In that case, it could not change its classification by election under this paragraph (c) during the sixty months succeeding the effective date of the election.

Example 2.

(i) Z is an eligible entity formed under Country B law and is in existence on the effective date of this section within the meaning of paragraph (b)(3) of this section. Prior to the effective date of this section, Z claimed to be classified as an association. Unless Z files an election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) *Authorized signatures —*

(i) *In general.* An election made under paragraph (c)(1)(i) of this section must be signed by—

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) *Retroactive elections.* For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(iii) *Changes in classification.* For paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after November 29, 1999.

(3) *Consent to be subject to section 1503(d) —*

(i) *Rule.* A domestic eligible entity that elects to be classified as an association consents to be treated as a dual resident corporation for purposes of section 1503(d) (such an entity, a *domestic consenting corporation*), for any taxable year for which it is classified as an association and the condition set forth in

§ 1.1503(d)-1(c)(1) of this chapter is satisfied.

(ii) *Transition rule—deemed consent.* If, as a result of the applicability date (see paragraph (c)(3)(iii) of this section) relating to paragraph (c)(3)(i) of this section, a domestic eligible entity that is classified as an association has not consented to be treated as a domestic consenting corporation pursuant to paragraph (c)(3)(i) of this section, then the domestic eligible entity is deemed to consent to be so treated as of its first taxable year beginning on or after December 20, 2019. The first sentence of this paragraph (c)(3)(ii) does not apply if the domestic eligible entity elects, on or after December 20, 2018 and effective before its first taxable year beginning on or after December 20, 2019, to be classified as a partnership or disregarded entity such that it ceases to be a domestic eligible entity that is classified as an association. For purposes of the election described in the second sentence of this paragraph (c)(3)(ii), the sixty month limitation under paragraph (c)(1)(iv) of this section is waived.

(iii) *Applicability date.* The sixth sentence of paragraph (a) of this section and paragraph (c)(3)(i) of this section apply to a domestic eligible entity that on or after December 20, 2018 files an election to be classified as an association (regardless of whether the election is effective before December 20, 2018). Paragraph (c)(3)(ii) of this section applies as of December 20, 2018.