

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 355(d); Recognition of Gain on Certain Distributions of Stock or Securities

REG-106004-98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation. These proposed regulations affect corporations and their shareholders. Proposed regulations are necessary because of statutory changes made by the Omnibus Budget Reconciliation Act of 1990. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by August 2, 1999. Outlines of topics to be discussed at the public hearing scheduled for September 21, 1999, at 10 a.m. must be received by August 31, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-106004-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-106004-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslst.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Robert Hawkes (202) 622-7530 or Phoebe Bennett (202) 622-7750; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

If the requirements of section 355(a) are met, a distributing corporation (Distributing) may distribute the stock or securities of a controlled corporation (Controlled) to its shareholders or security holders (Distributees) with no gain or loss recognized to the Distributees. A Distributee allocates its basis in Distributing stock or securities between the Controlled stock or securities received in the distribution and any Distributing stock or securities retained in proportion to the fair market value of each. See section 358; §§1.358-1 and 1.358-2. If neither section 355(d) nor (e) applies, then Distributing generally recognizes no gain on the distribution of stock or securities. See section 355(c)(2) or 361(c)(2).

With limited exceptions, the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 208) (TRA), repealed the doctrine of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), by requiring a corporation to recognize gain on both liquidating and nonliquidating distributions of appreciated property. In retaining section 355 as an exception to *General Utilities* repeal, Congress intended to permit historic shareholders to carry on their historic corporate businesses in separate corporations. See H. R. Rep. 101-881, at 341 (1990). However, Congress became concerned that, after the TRA, a person could purchase a historic shareholder's interest, receive a distribution of Controlled stock tax-free to both Distributing and the purchaser, and obtain a fair market value basis in the Controlled stock. Accordingly, Congress amended section 355(b)(2)(D) in the Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203, section 10223, 101

Stat. 1330-411) (1987 OBRA) to make section 355 inapplicable where a Distributee acquired control (as defined in section 368(c)) of a corporation conducting a business in a taxable transaction during the five-year period ending on the date of the distribution. See H. R. Rep. No. 100-391, at 1082-83 (1987). However, section 355(b)(2)(D) did not apply to noncorporate purchasers or purchasers of less than 80 percent of Distributing stock.

Section 355(d), enacted as part of the Omnibus Budget Reconciliation Act of 1990 (Public Law 101-508, section 11321(a), 104 Stat. 1388-460) (1990 OBRA), followed the purposes of the 1987 OBRA provisions but substantially expanded their scope. See H. R. Rep. 101-881, at 341 (1990). In section 355(d), Congress intended to prevent the use of section 355 either to "dispose of subsidiaries in transactions that resemble sales, or to obtain a fair market value stepped-up basis for any future dispositions, without incurring corporate-level tax." *Id.*

Section 355(d) requires recognition of gain on a distribution of Controlled stock (as though the Controlled stock were sold to the Distributee at its fair market value) if, immediately after the distribution, any person holds disqualified stock of Distributing or any distributed Controlled that constitutes a 50 percent or greater interest. See section 355(d)(1) and (2). Disqualified stock is stock in Distributing acquired by purchase after October 9, 1990 and during the five-year period (taking into account section 355(d)(6)) ending on the date of distribution (the five-year period), or Controlled stock either (1) acquired by purchase during the five-year period or (2) distributed with respect to either disqualified Distributing stock or on Distributing securities acquired by purchase during the five-year period. See section 355(d)(3). A 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. See section 355(d)(4). Section 355(d) also contains a definition of purchase (section 355(d)(5)), a provision suspending the

five-year period for certain stock or securities (section 355(d)(6)), and aggregation and attribution provisions (section 355(d)(7) and (8)). Section 355(d)(9) authorizes regulations to carry out the purposes of section 355(d), including regulations to prevent the avoidance of its purposes through the use of related persons, intermediaries, pass-through entities, options, or other arrangements, and regulations modifying the definition of purchase.

Explanation of Provisions

(a) General Rules and Purposes of Section 355(d)

As stated above, section 355(d) is intended to prevent taxpayers from using section 355 to dispose of subsidiaries in sale-like transactions, or to obtain a fair market value stepped-up basis for future dispositions, without incurring a corporate-level tax. See H. R. Rep. 101-881, at 341 (1990). The legislative history to section 355(d) describes transactions generally not violating the purposes of section 355(d):

The purposes of [section 355(d)] are not generally violated if there is a distribution of a controlled corporation within 5 years of an acquisition by purchase and the effect of the distribution is neither (1) to increase ownership in the distributing corporation or any controlled corporation by persons who have directly or indirectly acquired stock within the prior five years, nor (2) to provide a basis step-up with respect to the stock of any controlled corporation.

H. R. Rep. No. 101-964 (Conference Report), at 1093 (1990).

The Conference Report, at page 1091, clarifies that the grant of regulatory authority in section 355(d)(9) includes the authority to exclude from section 355(d) transactions not violating its purposes. The proposed regulations provide that a distribution is not a disqualified distribution under section 355(d)(2) and proposed § 1.355-6(b)(1) if the distribution and any related transactions do not violate the purposes of section 355(d). The proposed regulations describe transactions not violating the purposes of section 355(d) in a manner similar to the legislative history and provide some examples of those

transactions. If a distribution does not violate the purposes of section 355(d) under proposed § 1.355-6(b)(3), such distribution is a distribution to which section 355(d) does not apply. Accordingly, such a distribution still could be a distribution to which section 355(e) applies. See section 355(e)(2)(D).

The exception in the proposed regulations for transactions that do not violate the purposes of section 355(d) applies to transactions in which a disqualified person neither increases an interest nor obtains a purchased basis in Controlled stock. A disqualified person is any person that, immediately after a distribution, holds disqualified stock in Distributing or Controlled that constitutes a 50-percent or greater interest (under section 355(d)(4) and proposed § 1.355-6(c)). Based on examples in the Conference Report, the proposed regulations define *purchased basis* as basis in Controlled stock that is disqualified stock, unless the Controlled stock and the Distributing stock on which the Controlled stock is distributed are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and proposed § 1.355-6(e)(1). Examples in the proposed regulations demonstrate the application of the two-pronged purpose test.

The proposed regulations also provide that a person that acquires an interest in any entity by purchase is not treated as having acquired by purchase stock owned by the entity under section 355(d)(8)(B) and paragraph (e)(1) of this section when the person no longer holds the directly purchased interest. Examples demonstrate the operation of this rule when purchased stock is eliminated in a liquidation or upstream merger.

The proposed regulations provide an anti-avoidance rule that permits the Commissioner to treat any distribution as a disqualified distribution under section 355(d)(2) and proposed § 1.355-6(b)(1) if the distribution or another transaction or transactions are engaged in or structured with a principal purpose to avoid the purposes of section 355(d) or the regulations thereunder with respect to the distribution. For example, the Commissioner may determine that the existence of a related person, intermediary, pass-through entity, or similar person (an intermediary) should be disregarded, in whole or in part,

if the intermediary is formed or availed of with a principal purpose to avoid the purposes of section 355(d) or the regulations thereunder.

(b) Whether a Person Holds a 50 Percent or Greater Interest

Under section 355(d)(4), *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. The proposed regulations provide rules relating to that definition.

Valuation

The proposed regulations provide that, for purposes of section 355(d)(4) and proposed § 1.355-6, all shares of stock within a single class are considered to have the same value. But see proposed § 1.355-6(c)(3)(vii), which applies a special valuation rule to determine whether options are reasonably certain to be exercised.

Effect of Options, Warrants, Convertible Obligations, and Other Similar Interests

Section 355(d)(9) provides regulatory authority to prevent the avoidance of the purposes of section 355(d) through the use of options. The Conference Report states, at page 1092, that Congress intends that regulations be issued to treat an option to acquire stock as exercised if two criteria are satisfied. The first is that a deemed exercise would cause a person to have a 50 percent or greater interest acquired by purchase. The second is that, under all the facts and circumstances (including projected earnings or appreciation and including the risk shifting or other effects of any other arrangements with the option holder or related parties), the effect of the option would be to avoid the application of section 355(d).

In general, the proposed regulations disregard options in determining whether any person holds disqualified stock constituting a 50 percent or greater interest. However, under the proposed regulations, an option to acquire stock that has not been exercised when a distribution occurs is treated as exercised on the date it was issued or most recently transferred if two criteria are satisfied. The first, based on the Conference Report, is that a deemed

exercise would cause a person to become a disqualified person. An option is not treated as exercised under this criterion, however, if the effect of the treatment is to prevent a person who would otherwise be a disqualified person from being treated as a disqualified person. The second criterion is that, immediately after the distribution of Controlled, and based on all the facts and circumstances, it is reasonably certain that the option will be exercised. The IRS and Treasury believe that the proposed regulations, which employ a “reasonably certain” standard to treat options as exercised in potentially abusive situations, is consistent with the guidance given in the Conference Report with respect to options. The proposed regulations generally except certain instruments not ordinarily having an abuse potential from treatment as options, such as escrow, pledge, or other security agreements, compensatory options, and options exercisable only upon death, disability, mental incompetency, or retirement.

When an option is treated as exercised, it is treated as exercised both for purposes of determining the percentage of the voting power of stock owned and for purposes of determining the percentage of the value of stock owned. The effect of control premiums and minority and blockage discounts on stock value is taken into account only for purposes of applying the “reasonably certain” test. If the “reasonably certain” test is met, so that an option is treated as exercised, all shares of a single class are considered to have the same value for purposes of determining the amount of stock deemed acquired under the option.

The option rules of proposed §1.355-6(c)(3) determine when an option is treated as exercised only for purposes of section 355(d) (but not for purposes of section 355(d)(6)) and do not apply for purposes of any other sections of the Internal Revenue Code. The option rules are proposed to apply generally to options outstanding in distributions occurring after the regulations are published as final regulations in the **Federal Register**. See proposed §1.355-6(g). However, the Service may apply substance over form principles in determining whether options outstanding in distributions before the effective date are treated as stock or as exercised in appropriate circumstances.

Plan or Arrangement

Under section 355(d)(7)(B), if two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock or securities in Distributing or Controlled, those persons are treated as one person for purposes of section 355(d). The proposed regulations provide a rule to determine when shareholders act pursuant to a plan or arrangement. Under the rule (which does not apply for purposes of any other section of the Internal Revenue Code), two or more shareholders act pursuant to a plan or arrangement only if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. Thus, in general, a public offering is not treated as a plan or arrangement if each investor makes an independent investment decision. This rule applies regardless of the amount of stock the shareholders own or acquire. The rule is based on the entity rule contained in §1.382-3(a)(1), and the IRS and Treasury intend that the two provisions be administered in a similar manner.

The proposed regulations provide that creditors’ participation in an insolvency workout or reorganization in a title 11 or similar case, and the receipt of stock in satisfaction of indebtedness in a workout or reorganization, are not treated as a plan or arrangement among the creditors. The IRS and Treasury request comments as to whether additional provisions are appropriate for workout or bankruptcy situations, such as rules regarding the timing of purchases of stock received by creditors, or rules regarding whether rights created in favor of creditors in a bankruptcy case should be treated as options.

(c) *Purchase*

Under section 355(d)(5)(A), except as otherwise provided in section 355(d)(5)-(B) and (C), a purchase means any acquisition, but only if (1) the basis of the property acquired in the hands of the acquirer is not determined in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or under section 1014(a),

and (2) the property is not acquired in an exchange to which section 351, 354, 355, or 356 applies. The proposed regulations clarify that the term *exchange* in the statute includes a reference to all section 355 distributions (for example, spin-offs, even though no property is conveyed in exchange for the distributed stock).

Exceptions to Definition of Purchase Under Section 355(d)(5)(A)

The proposed regulations provide that an acquisition of stock permitted to be received by a transferor of property without the recognition of gain under section 351(a), or permitted to be received without the recognition of gain under section 354 or 355, is not a purchase to the extent section 358(a)(1) applies to determine the recipient’s basis, whether or not the recipient also recognizes gain under section 351(b) or 356. The Conference Report suggests, at page 1092, that regulations generally should treat stock received by a target corporation shareholder in a reorganization as acquired by purchase if the shareholder also receives boot. The Conference Report states that purchase treatment is warranted because the basis in the shareholder’s acquiring corporation stock is increased by the gain the shareholder recognizes. However, under section 358(a)(1)(A), the basis in the stock also is reduced by the amount of the boot received. Thus, the shareholder will not receive a net basis increase in the acquiring corporation stock. The proposed regulations also provide that, to the extent stock that is “other property” under section 351(b) or 356(a)(1) is received in addition to stock excepted from purchase treatment under the basic rule, the boot stock is treated as purchased on the date of the exchange or distribution for purposes of section 355(d).

The proposed regulations provide that an acquisition of stock by a corporation is generally not a purchase to the extent section 334(b) or 362(a) or (b) applies to determine the corporation’s basis in the stock received. However, because of the basis results, stock is treated as purchased on the date of the stock acquisition for purposes of section 355(d) if the liquidating corporation recognizes gain or loss with respect to the transferred stock as described in section 334(b)(1), or to the ex-

tent the basis of the transferred stock is increased through the recognition of gain by the transferor under section 362(a) or (b).

The proposed regulations provide that, subject to certain restrictions, section 305(a) and section 1036(a) transactions are not purchases.

Certain Section 351 Exchanges Treated as Purchases

Under section 355(d)(5)(B), a purchase includes any acquisition of property in an exchange to which section 351 applies to the extent the property is acquired in exchange for any cash or cash item, any marketable stock or security, or any debt of the transferor. The property treated as acquired by purchase is the property received by the transferor in the exchange. If the transferor receives more than one class of stock or securities, or receives both stock and securities, the proposed regulations provide that the amount of stock or securities purchased is determined in a manner that corresponds to the basis allocation under section 358. The proposed regulations define the terms *cash item* and *marketable stock* to include personal property within the meaning of section 1092(d)(1) and §1.1092(d)-1, without giving effect to section 1092(d)(3).

The proposed regulations provide certain exceptions to purchase treatment under section 355(d)(5)(B). Under the first exception, an acquisition of stock in a corporation in a section 351(a) transaction by one or more persons in exchange for an amount of stock in another corporation (the transferred corporation) that meets the requirements of section 1504(a)(2) is not a purchase by the transferor or transferors, regardless of whether the stock of the transferred corporation is marketable stock. Under the second exception, an acquisition of stock in exchange for any cash or cash item, any marketable stock, or any debt of the transferor in a section 351 transaction generally is not a purchase if the transferor transfers the items as part of an active trade or business and the transferred items do not exceed the reasonable needs of the trade or business. This exception is based on the Conference Report, at page 1093. The proposed regulations provide guidance based on §1.355-3(b)(2) and (3) for

determining active conduct of a trade or business and guidance on the reasonable needs of the trade or business. All facts and circumstances are considered in applying the exception.

The third exception, also based on the Conference Report, at pages 1092-93, provides that an acquisition of stock in exchange for any cash or cash item, marketable stock or security, or debt of the transferor in a section 351 transaction is generally not a purchase if the transferor corporation or corporations, the transferee corporation, and any distributed controlled corporation of the transferee corporation are members of the same affiliated group as defined in section 1504(a) before the section 351 transaction (if the transferee corporation is in existence before the transaction) and do not cease to be members of such affiliated group in any transaction related to the section 351 transaction (including any distribution of a controlled corporation by the transferee corporation). An example illustrates that, under the anti-avoidance rule of proposed §1.355-6(b)(4), this exception does not apply if the section 351 transaction is engaged in or structured with a principal purpose to avoid the purposes of section 355(d).

The proposed regulations provide purchase rules for certain triangular asset reorganizations. For purposes of section 355(d), the proposed regulations generally treat the controlling corporation as having acquired the assets and liabilities of the target corporation in a transaction in which basis in the acquired assets is determined under section 362(b) and then transferred the assets and liabilities to its subsidiary corporation in a section 351 transaction. This treatment is consistent with the determination of basis in the stock of the acquiring subsidiary or target corporation under §1.358-6. The application of section 351 to the deemed asset contribution causes section 355(d)(5)(B) (and proposed §1.355-6(d)(3)(i) through (iv)) to apply.

The proposed regulations provide special rules for transactions qualifying as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) and also as either a reorganization under section 368(a)(1)(B) or a section 351 transfer. Special rules are necessary for these

transactions because, under §1.358-6(c)(2)(ii) or 1.1502-30(b), a controlling corporation may determine its basis in surviving corporation stock by choosing from two alternative methods, but the taxpayer need not choose a method until a basis determination is relevant. The proposed regulations describe corresponding methods for determining the amount of surviving corporation stock treated as purchased for purposes of section 355(d). The proposed regulations provide that, regardless of which method the controlling corporation may actually employ to determine its basis in the surviving corporation stock under §1.358-6(c)(2)(ii) or 1.1502-30(b), the total amount of surviving corporation stock treated as purchased immediately after the distribution equals the higher of the amount of surviving corporation stock that would be treated as purchased under the two alternative methods described in proposed §1.355-6(d)(5)(i). The proposed regulations allow a controlling corporation to select one of the two alternative methods if the controlling corporation obtains a letter ruling and enters into a closing agreement under section 7121 in which it agrees to determine its basis in surviving corporation stock using the corresponding method under §1.358-6(c)(2)(ii)(A) or (B). This option allows the taxpayer to conform the section 355(d) results with the section 358 basis results it chooses.

Finally, the proposed regulations explain the treatment of group structure changes to which §1.1502-31 applies, and provide rules adjusting purchase treatment to conform to basis treatment in triangular reorganizations and group structure changes.

(d) Deemed Purchase and Timing Rules

Attribution and Aggregation

Under section 355(d)(8)(B), if any person purchases an interest in an entity, and any stock held by the entity is attributed to the person under section 355(d)(8)(A), the person is treated as purchasing the stock on the later of the date the person purchased the interest in the entity or the date the entity purchased the stock.

The proposed regulations adopt three additional timing rules based on the Conference Report, at page 1090. First, if a

person and an entity are treated as a single person under section 355(d)(7), and the person later purchases an additional interest in the entity, the person is treated as purchasing, at the time the additional interest is purchased, the amount of stock attributed from the entity to the person as a result of the additional interest. This timing rule applies even though the person was (prior to purchasing the additional interest in the entity) already treated as owning all of the stock owned by the entity under the aggregation rules of section 355(d)(7). Second, if two persons are treated as one person under section 355(d)(7) and one later purchases stock from the other, the date of the later purchase is used. Third, if a person who is already treated as holding stock under section 355(d)(8)(A) later directly purchases such stock, the date of the later direct purchase is used. The proposed regulations contain a series of examples, similar to those on pages 1090 and 1091 of the Conference Report, demonstrating the operation of these rules.

Transferred Basis Rule

Under section 355(d)(5)(C), if any person acquires property from another person who acquired the property by purchase, and the adjusted basis of the property in the hands of the acquirer is determined in whole or in part by reference to the adjusted basis of the property in the hands of the other person, the acquirer is treated as having acquired the property by purchase on the date it was acquired by the other person. This rule applies, for example, where stock of a corporation with a purchased basis is acquired in a section 351 transfer or a reorganization qualifying under section 368(a)(1)(B), but does not apply if the stock of a former common parent is acquired in a group structure change.

Under proposed §1.355-6(d)(2)(i)-(B)(2), transferred stock is treated as purchased on the date of a transfer if the stock is transferred in a liquidation, and the liquidating corporation recognizes gain or loss with respect to the transferred stock as described in section 334(b)(1), or to the extent the basis of the transferred stock is increased through the recognition of gain by the transferor under section 362(a) or (b).

Exchanged Basis Rule

Based on the Conference Report, at page 1092, the proposed regulations adopt a rule that, if any person acquires an interest in an entity (the first interest) by purchase, and the first interest is exchanged for an interest in another entity (the second interest) where the adjusted basis of the second interest is determined by reference to the adjusted basis of the first interest, then the second interest is treated as having been purchased on the date the first interest was purchased. This rule applies, for example, where stock of a corporation acquired by purchase is subsequently exchanged for other stock in a section 351, 354, or 1036(a) exchange. Under proposed §1.355-6(d)(2)(i)(A)(2), stock that is other property under section 351(b) or 356(a)(1) is treated as purchased on the date of the exchange or distribution.

Substantial Diminution of Risk

As in section 355(d)(6), the proposed regulations provide that the running of the five-year period under section 355(d)(3) is suspended for any period during which the holder's risk of loss is substantially diminished by an option, a short sale, any special class of stock (including tracking stock), or any other device or transaction.

(e) *Duty to Determine Stockholders and Presumptions*

The proposed regulations provide that, in determining whether section 355(d) applies to a distribution, Distributing must determine whether a disqualified person holds its stock or the stock of any distributed Controlled. For this purpose, a corporation is deemed to have knowledge of the existence and contents of all schedules, forms, and other documents filed with or under the rules of the Securities and Exchange Commission, including, without limitation, any Schedule 13D or 13G (or any similar schedules) and amendments, with respect to any relevant corporation.

The proposed regulations provide that, absent actual knowledge to the contrary, with respect to reporting stock, Distributing may presume that all schedules, forms, or other documents are timely filed, accurate, and complete. *Reporting*

stock is defined as stock that is described in Rule 13d-1(i) of Regulation 13D promulgated under the Securities and Exchange Act of 1934. In addition, the proposed regulations provide a presumption with respect to *less-than-five-percent shareholders*, which are defined as persons that, at no time during the five-year period, hold directly (or under the option rules contained in the proposed regulations) stock possessing five percent or more of the total combined voting power of all classes of stock entitled to vote and the total value of shares of all classes of stock of a corporation. Absent actual knowledge (or deemed knowledge regarding reporting stock) immediately after a distribution to the contrary regarding a particular shareholder, Distributing may generally presume that no less-than-five-percent shareholder of a corporation acquired stock by purchase during the five-year period. This presumption does not apply to any less-than-five-percent shareholder that, at any time during the five-year period, is related to, acted pursuant to a plan or arrangement with, or holds stock that is attributed to a shareholder that is not a less-than-five-percent shareholder at any time during the five-year period. If an acquiring corporation acquires Distributing in a transferred basis transaction, Distributing may apply both the reporting stock presumption and the less-than-five-percent shareholder presumption to determine whether section 355(d) applies to a distribution of Controlled stock to the acquiring corporation due to preacquisition stock purchases by Distributing's former shareholders.

Proposed Effective Date

The proposed regulations would apply to distributions occurring after the regulations are published as final regulations in the **Federal Register**, except that they would not apply to any distributions occurring pursuant to a written agreement which is (subject to customary conditions) binding on the date the regulations are published as final regulations in the **Federal Register**, and at all times thereafter.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a signifi-

section 355(d) as provided in this paragraph (b)(3). A distribution does not violate the purposes of section 355(d) if the effect of the distribution and any related transactions is neither—

(A) To increase direct or indirect ownership in the distributing corporation or any controlled corporation by a disqualified person; nor

(B) To provide a disqualified person with a purchased basis in the stock of any controlled corporation.

(i) *Disqualified person.* A disqualified person is any person (taking into account section 355(d)(7) and paragraph (c)(4) of this section) that, immediately after a distribution, holds (directly or indirectly under section 355(d)(8) and paragraph (e)(1) of this section) disqualified stock in the distributing corporation or controlled corporation that constitutes a 50 percent or greater interest in such corporation (under section 355(d)(4) and paragraph (c) of this section).

(ii) *Purchased basis.* A purchased basis is basis in controlled corporation stock that is disqualified stock, unless the controlled corporation stock and any distributing corporation stock with respect to which the controlled corporation stock is distributed are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section.

(iii) *Purchased interest no longer held.* A person that acquires an interest in any entity by purchase ceases to be treated as having acquired by purchase stock owned by the entity under section 355(d)(8)(B) and paragraph (e)(1) of this section at the time when the person no longer holds the directly purchased interest.

(v) *Examples.* The following examples illustrate this paragraph (b)(3):

Example 1. Stock distributed in spin-off; no purchased basis. D owns all of the stock of D1, and D1 owns all the stock of C. A purchases 60 percent of the D stock for cash. Within five years of A's purchase, D1 distributes the C stock to D. A is treated as having purchased 60 percent of the stock of both D1 and C on the date A purchases 60 percent of the D stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by D is attributable to a distribution on purchased D1 stock under section 355(d)(3)(B)(ii). Accordingly, the D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. However, the purposes of section 355(d) under paragraph (b)(3)(i)

of this section are not violated. A did not increase direct or indirect ownership in D1 or C. In addition, D's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section because both the D1 and the C stock are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D1's distribution of the C stock to D is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. Stock distributed in spin-off; purchased basis. The facts are the same as *Example 1*, except that D immediately further distributes the C stock to its shareholders (including A) pro rata. The D and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. A did not increase direct or indirect ownership in D or C. However, A's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, the further distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 3. Stock distributed in split-off with ownership increase; purchased basis. The facts are the same as *Example 1*, except that D immediately further distributes the C stock to A in exchange for A's purchased stock in D. The C stock received by A is attributable to a distribution on purchased D stock under section 355(d)(3)(B)(ii), and A's basis in the C stock is determined by reference to the adjusted basis of A's purchased D stock under paragraph (e)(3) of this section. Accordingly, the D stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated because A increased its ownership in C from a 60 percent indirect interest to a 100 percent direct interest, and because A's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section. Accordingly, the further distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 4. Stock distributed in spin-off; purchased basis. D1 owns all the stock of C. D purchases all of the stock of D1 for cash. Within five years of D's purchase of D1, P acquires all of the stock of D1 from D in a section 368(a)(1)(B) reorganization that is not a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E), and D1 distributes all of its C stock to P. P is treated as having acquired the D1 stock by purchase on the date D acquired it under the transferred basis rule of section 355(d)(5)(C) and paragraph (e)(2) of this section. P is treated as having purchased all of the C stock on the date D purchased the D1 stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section, and the C stock received by P is attributable to a distribution on purchased D1 stock under section 355(d)(3)(B)(ii). Accordingly, the D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this sec-

tion, and P is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. P did not increase direct or indirect ownership in D1 or C. However, P's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D1 stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D1's distribution of the C stock to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 5. Stock distributed in split-off with ownership increase; no purchased basis. P owns 50 percent of the stock of D, the remaining D stock is owned by unrelated persons, D owns all the stock of C, and A purchases all of the P stock from the P shareholders. Within five years of A's purchase, D distributes all of the C stock to P in exchange for P's D stock. A is treated as having purchased 50 percent of the stock of both D and C on the date A purchases the P stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by P is attributable to a distribution on purchased D stock under section 355(d)(3)(B)(ii). Accordingly, the D stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated because, even though P's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section, A increased its direct or indirect ownership in C from a 50 percent indirect interest to a 100 percent indirect interest. Accordingly, D's distribution of the C stock to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 6. Stock distributed in split-off with ownership increase; no purchased basis. A purchases all of the stock of T. T later merges into D in a section 368(a)(1)(A) reorganization and A exchanges its purchased T stock for 60 percent of the stock of D. D owns all of the stock of D1 and D2, D1 and D2 each owns 50 percent of the stock of D3, and D3 owns all of the stock of C. Within five years of A's purchase of the T stock, D3 distributes the C stock to D1 in exchange for all of D1's D3 stock. A is treated as having acquired 60 percent of the D stock by purchase on the date A purchases the T stock under paragraph (e)(3) of this section. A is treated as having purchased 60 percent of the stock of D1, D2, D3, and C on the date A purchases the T stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by D1 is attributable to a distribution on purchased D3 stock under section 355(d)(3)(B)(ii). Accordingly, the D3 stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. However, the purposes of section 355(d) under paragraph (b)(3)(i) of this section are not violated. A did not increase direct or indirect ownership in D3 or C, and D1's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section because the D3 stock is treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Ac-

cordingly, D3's distribution of the C stock to D1 is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 7. Purchased basis eliminated by liquidation; stock distributed in spin-off. P owns 30 percent of the stock of D, D owns all of the stock of D1, and D1 owns all of the stock of C. P purchases the remaining 70 percent of the D stock for cash. Within five years of P's purchase, P liquidates D in a transaction qualifying under sections 332 and 337(a), and D1 then distributes the stock of C to P. Prior to the liquidation, P is treated as having purchased 70 percent of the stock of D1 and C on the date P purchases the D stock under the attribution rules of section 355(d)(8)(B) and paragraph (e)(1) of this section. After the liquidation, however, under paragraph (b)(3)(iv) of this section, P is not treated as having acquired by purchase the D1 or the C stock under section 355(d)(8)(B) and paragraph (e)(1) of this section because P no longer holds the directly purchased interest in D. Under section 334(b)(1), P's basis in the D1 stock is determined by reference to D's basis in the D1 stock and not by reference to P's basis in D. Paragraph (d)(2)(i)(B) of this section does not treat the D1 stock as newly purchased in P's hands because no gain or loss was recognized by D in the liquidation. Accordingly, neither the D1 stock nor the C stock is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section in P's hands, and the distribution is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 8. Purchased basis eliminated by upstream merger; stock distributed in spin-off. D owns all of the stock of D1, and D1 owns all of the stock of C. P purchases 60 percent of the D stock for cash. Within five years of P's purchase, D merges into P in a section 368(a)(1)(A) reorganization, with the D shareholders other than P receiving solely P stock in exchange for their D stock, and D1 then distributes the stock of C to P. Prior to the merger, P is treated as having purchased 60 percent of the stock of D1 and C on the date P purchases the D stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. After the merger, however, under paragraph (b)(3)(iv) of this section, P is not treated as having acquired by purchase the D1 or the C stock under section 355(d)(8)(B) and paragraph (e)(1) of this section because P no longer holds the directly purchased interest in D. Under section 362(b), P's basis in the D1 stock is determined by reference to D's basis in the D1 stock and not by reference to P's basis in D. Paragraph (d)(2)(i)(B) of this section does not treat the D1 stock as newly purchased in P's hands because no gain or loss was recognized by D in the merger. Accordingly, neither the D1 stock nor the C stock is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section in P's hands, and the distribution is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

(4) *Anti-avoidance rule*—(i) *In general.* Notwithstanding any provision of section 355(d) or this section, the Commissioner may treat any distribution as a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this

section if the distribution or another transaction or transactions are engaged in or structured with a principal purpose to avoid the purposes of section 355(d) or this section with respect to the distribution. Without limiting the preceding sentence, the Commissioner may determine that the existence of a related person, intermediary, pass-through entity, or similar person (an intermediary) should be disregarded, in whole or in part, if the intermediary is formed or availed of with a principal purpose to avoid the purposes of section 355(d) or this section.

(ii) *Example.* The following example illustrates this paragraph (b)(4):

Example. Post-distribution redemption. B wholly owns D, which wholly owns C. With a principal purpose to avoid the purposes of section 355(d), A, B, D, and C engage in the following transactions. A purchases 45 of 100 shares of the only class of D stock. Within five years after A's purchase, D distributes all of its 100 shares in C to A and B pro rata. D then redeems 20 shares of B's D stock, and C redeems 20 shares of B's C stock. After the redemption, A owns 45 shares and B owns 35 shares in each of D and C. Under paragraph (b)(4)(i) of this section, the Commissioner may treat A as owning disqualified stock in D and C that constitutes a 50 percent or greater interest in D and C immediately after the distribution. Under that treatment, the distribution is a disqualified distribution under section 355(d)(2).

(c) *Whether a person holds a 50 percent or greater interest*—(1) *In general.* Under section 355(d)(4), *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.

(2) *Valuation.* For purposes of section 355(d)(4) and this section, all shares of stock within a single class are considered to have the same value. But see paragraph (c)(3)(vii)(A) of this section (determination of whether it is reasonably certain that an option will be exercised).

(3) *Effect of options, warrants, convertible obligations, and other similar interests*—(i) *Application.* This paragraph (c)(3) provides rules to determine when an option is treated as exercised for purposes of section 355(d) (other than section 355(d)(6)). Except as provided in this paragraph (c)(3), an option is not treated as exercised for purposes of section 355(d). This paragraph (c)(3) does not affect the determination of whether an

instrument is an option or stock under general principles of tax law (such as substance over form).

(ii) *General rule.* In determining whether a person has acquired by purchase a 50 percent or greater interest under section 355(d)(4), an option to acquire stock (as described in paragraphs (c)(3)(v) and (vi) of this section) that has not been exercised when a distribution occurs is treated as exercised on the date it was issued or most recently transferred if—

(A) Its exercise (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause a person to become a disqualified person; and

(B) Immediately after the distribution, it is reasonably certain (as described in paragraph (c)(3)(vii) of this section) that the option will be exercised.

(iii) *Options deemed newly issued*—

(A) *Exchange, adjustment, or alteration of existing option.* For purposes of this paragraph (c)(3), each of the following is treated as a new issuance or transfer of an existing option only if it materially increases the likelihood that an option will be exercised—

(1) An exchange of an option for another option or options;

(2) An adjustment to the terms of an option (including an adjustment pursuant to the terms of the option);

(3) An adjustment to the terms of the underlying stock (including an adjustment pursuant to the terms of the stock);

(4) A change to the capital structure of the issuing corporation; and

(5) An alteration to the fair market value of issuing corporation stock through an asset transfer (other than regular, ordinary dividends) or through any other means.

(B) *Certain compensatory options.* An option described in paragraph (c)(3)(vi)-(B)(2) of this section is treated as issued on the date it becomes transferable.

(iv) *Effect of treating an option as exercised*—(A) *In general.* For purposes of section 355(d), an option that is treated as exercised under this paragraph (c)(3) is treated as exercised both for purposes of determining the percentage of the voting power of stock owned by the holder and for purposes of determining the percentage of the value of stock owned by the holder.

(B) *Cash settlement options, phantom stock, stock appreciation rights, certain notional principal contracts, or similar interests.* If a cash settlement option, phantom stock, stock appreciation right, notional principal contract described in paragraph (c)(3)(v)(B) of this section, or similar interest is treated as exercised, the option is treated as having been converted into stock of the issuing corporation. If the amount to be received upon the exercise of such an option is determined by reference to a multiple of the increase in the value of a share of the issuing corporation's stock on the exercise date over the value of a share of the stock on the date the option is issued, the option is treated as converted into a corresponding number of shares of such stock. Appropriate adjustments must be made in any situation in which the amount to be received upon exercise of the option is determined in another manner.

(C) *Stock purchase agreement or similar arrangement.* If a stock purchase agreement or similar arrangement is deemed exercised, the purchaser is treated as having purchased of the stock under the terms of the agreement or arrangement as though all covenants had been satisfied and all contingencies met. The agreement or arrangement is deemed to have been exercised as of the date it is entered into or most recently assigned.

(v) *Instruments treated as options.* For purposes of this paragraph (c)(3), except to the extent provided in paragraph (c)(3)(vi) of this section, the following are treated as options:

(A) A call option, warrant, convertible obligation, the conversion feature of convertible stock, put option, redemption agreement (including a right to cause the redemption of stock), notional principal contract (as defined in §1.446-3(c)) that provides for the payment of amounts in stock, stock purchase agreement or similar arrangement, or any other instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option).

(B) A cash settlement option, phantom stock, stock appreciation right, notional principal contract (as defined in §1.446-3(c)) that provides for payment based on the price of stock, or any other similar interest (except for stock).

(vi) *Instruments generally not treated as options.* For purposes of this paragraph

(c)(3), the following are not treated as options, unless issued, transferred, or listed with a principal purpose to avoid the application of section 355(d) or this section:

(A) *Escrow, pledge, or other security agreements.* An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(B) *Compensatory options—(1) General rule.* An option to acquire stock in a corporation with customary terms and conditions provided to an employee, director, or independent contractor in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) and that—

(i) Is nontransferable within the meaning of §1.83-3(d); and

(ii) Does not have a readily ascertainable fair market value as defined in §1.83-7(b).

(2) *Exception.* Paragraph (c)(3)(vi)(B)-(1) of this section ceases to apply to an option that becomes transferable.

(C) *Certain stock conversion features.* The conversion feature of convertible stock, provided that—

(1) The stock is not convertible for at least five years after issuance or transfer; and

(2) The terms of the conversion feature do not require the tender of any consideration other than the stock being converted.

(D) *Options exercisable only upon death, disability, mental incompetency, or retirement.* Any option entered into between stockholders of a corporation (or a stockholder and the corporation) with respect to the stock of either stockholder that is exercisable only upon the death, disability, mental incompetency of the stockholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the stockholder's retirement.

(E) *Rights of first refusal.* A bona fide right of first refusal regarding the corporation's stock with customary terms, entered into between stockholders of a corporation (or between the corporation and a stockholder).

(F) *Other enumerated instruments.* Any other instruments specified in regulations, a revenue ruling, or a revenue procedure. See §601.601(d)(2) of this chapter.

(vii) *Reasonably certain that the option will be exercised—(A) In general.* The determination of whether, immediately after the distribution, an option is reasonably certain to be exercised is based on all the facts and circumstances. In applying the previous sentence, the fair market value of stock underlying an option is determined by taking into account control premiums and minority and blockage discounts.

(B) *Stock purchase agreement or similar arrangement.* A stock purchase agreement or similar arrangement is treated as reasonably certain to be exercised if the parties' obligations to complete the transaction are subject only to reasonable closing conditions.

(viii) *Examples.* The following examples illustrate this paragraph (c)(3):

Example 1. D owns all of the stock of C. A purchases 40 percent of D's only class of stock and an option to purchase an additional 20 percent of the D stock. Assume that no control premium or minority or blockage discount applies to the D stock underlying the option. The option permits A to acquire the stock at \$30 per share, and D's stock has a fair market value of \$27 per share on the date the option is issued. The option is subject to no contingencies or restrictive covenants, may be exercised within five years after its issuance, and is not described in paragraph (c)(3)(vi) of this section (regarding instruments generally not treated as options). Within five years of A's purchase of the D stock and option, D distributes the stock of its subsidiary C pro rata and A receives 40 percent of the C stock in the distribution. Immediately after the distribution, D's stock has a fair market value of \$30 per share and C's stock has a fair market value of \$15 per share. At the time of the distribution, A exchanges A's option for an option to purchase 20 percent of the D stock at \$20 per share and an option to purchase 20 percent of the C stock at \$10 per share. Based on all the facts and circumstances, it is reasonably certain, immediately after the distribution, that A will exercise its options. Under paragraph (c)(3)(iii)(A)(1) of this section, the substituted options are treated as issued on the date the original option was issued. Accordingly, the options are treated as exercised by A on the date that A purchased the original option. A is treated as owning 60 percent of the D stock and 60 percent of the C stock that is disqualified stock, and the distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. D owns all of the stock of C. A purchases 37 percent of D's only class of stock. B owns 38 percent of the D stock, and the remaining 25 percent is owned by 20 individuals, each of whom owns less than five percent of D's stock. A purchases an option to purchase an additional 14 percent of the D stock from shareholders other than B for \$50 per share. The option is subject to no contingencies or restrictive covenants, may be exercised within five years after its issuance, and is not described in paragraph (c)(3)(vi) of this section. Within five years of A's purchase of the option and 37 percent interest in D, D distributes the stock of its subsidiary C pro rata and A receives 37 percent of the C stock in the distribution. At the time of the distribution, A exchanges its option for an option to purchase 14 percent of the D stock at \$25 per share and an option to purchase 14 percent of the C stock at \$25 per share. Assume that, although a shareholder that owned no D or C stock would pay only \$20 per share for D or C stock immediately after the distribution, a shareholder in A's position would pay \$30 per share for 14 percent of the stock of D or C because of the control premium which attaches to the shares. The control premium is taken into account under paragraph (c)(3)(vii)(A) of this section to determine whether A is reasonably certain to exercise the options. Based on all the facts and circumstances, it is reasonably certain, immediately after the distribution, that A will exercise its options. Under paragraph (c)(3)(iii)(A) of this section, the substituted options are treated as issued on the date the original option was issued. Accordingly, the options are treated as exercised by A on the date that A purchased the original option. Under paragraph (c)(2) of this section, all shares of D and C are considered to have the same value to determine the amount of stock A is treated as purchasing under the options. A is treated as owning 51 percent of the D stock and 51 percent of the C stock that is disqualified stock, and the distribution is a disqualified distribution under section 355(d)(2).

(4) *Plan or arrangement*—(i) *In general.* Under section 355(d)(7)(B), if two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock in the distributing corporation or controlled corporation, those persons are treated as one person for purposes of section 355(d).

(ii) *Understanding.* For purposes of section 355(d)(7)(B), two or more persons who are (or will after an acquisition become) shareholders (or are treated as shareholders under paragraph (c)(3)(ii) of this section) act pursuant to a plan or arrangement with respect to an acquisition of stock only if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment deci-

sion of one or more other existing or prospective shareholders. However, the participation by creditors in formulating a plan for an insolvency workout or a reorganization in a title 11 or similar case (whether as members of a creditors' committee or otherwise) and the receipt of stock by creditors in satisfaction of indebtedness pursuant to the workout or reorganization do not cause the creditors to be considered as acting pursuant to a plan or arrangement.

(iii) *Examples.* The following examples illustrate paragraph (c)(4)(ii) of this section:

Example 1. D has 1,000 shares of common stock outstanding. A group of 20 unrelated individuals who previously owned no D stock (the Group) agree among themselves to acquire 50 percent or more of D's stock. The Group is not a person under section 7701(a)(1). Subsequently, pursuant to their understanding, the members of the Group purchase 600 shares of D common stock from the existing D shareholders (a total of 60 percent of the D stock), with each member purchasing 30 shares. Under paragraph (c)(4)(ii) of this section, the members of the Group have a formal or informal understanding among themselves to make a coordinated acquisition of stock. Their interests are therefore aggregated under section 355(d)(7)(B), and they are treated as one person who purchased 600 shares of D's stock for purposes of section 355(d).

Example 2. D has 1,000 shares of outstanding stock owned by unrelated individuals. D's management is concerned that D may become subject to a takeover bid. In separate meetings, D's management meets with potential investors who own no stock and are friendly to management to convince them to acquire D's stock based on an understanding that D will assemble a group that in the aggregate will acquire more than 50 percent of D's stock. Subsequently, 15 of these investors each purchases four percent of D's stock. Under paragraph (c)(4)(ii) of this section, the 15 investors have a formal or informal understanding among themselves to make a coordinated acquisition of stock. Their interests are therefore aggregated under section 355(d)(7)(B), and they are treated as one person who purchased 600 shares of D stock for purposes of section 355(d).

Example 3. (i) D has 1,000 shares of outstanding stock owned by unrelated individuals. An investment advisor advises its clients that it believes D's stock is undervalued and recommends that they acquire D stock. Acting on the investment advisor's recommendation, 20 unrelated individuals each purchases 30 shares of D stock. Each client's decision was not based on the investment decisions made by one or more other clients. Because there is no formal or informal understanding among the clients to make a coordinated acquisition of D stock, their interests are not aggregated under section 355(d)(7)(B) and they are treated as making separate purchases.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that the investment advisor is

also the underwriter (without regard to whether it is a firm commitment or best efforts underwriting) for a primary or secondary offering of D stock. The result is the same.

(iii) The facts are the same as in paragraph (i) of this *Example 3*, except that, instead of an investment advisor recommending that clients purchase D stock, the trustee of several trusts qualified under section 401(a) sponsored by unrelated corporations causes each trust to purchase the D stock. The result is the same, provided that the trustee's investment decision made on behalf of each trust was not based on the investment decision made on behalf of one or more of the other trusts.

(d) *Purchase*—(1) *In general*—(i) *Definition of purchase under section 355(d)(5)(A).* Under section 355(d)(5)(A), except as otherwise provided in section 355(d)(5)(B) and (C), a *purchase* means any acquisition, but only if—

(A) 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

(2) Under section 1014(a); and

(B) The property is not acquired in an exchange to which section 351, 354, 355, or 356 applies.

(ii) *Section 355 distributions.* Paragraph (d)(1)(i)(B) of this section includes all section 355 distributions, whether in exchange (in whole or in part) for stock or pro rata.

(iii) *Examples.* The following examples illustrate this paragraph (d)(1):

Example 1. Section 304(a)(1) acquisition. A, who owns all of the stock of P and T, sells the T stock to P for cash. The T stock is not marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section. A is treated under section 304(a)(1) as receiving a distribution in redemption of the P stock. Under section 302(d), the deemed redemption is treated as a section 301 distribution. Assume that under sections 304(b)(2) and 301(c)(1), all of the distribution is a dividend. A and P are treated in the same manner as if A had transferred the T stock to P in exchange for stock of P in a transaction to which section 351(a) applies, and P had then redeemed the stock P was treated as issuing in the transaction. Under section 362(a), P's basis in the T stock is determined by reference to A's adjusted basis in the T stock, and there is no basis increase in the T stock because A recognizes no gain on the deemed transfer. Accordingly, P's acquisition of the T stock from A is not a purchase by P under section 355(d)(5)(A)(i)(I) and paragraphs (d)(1)(i)(A)(I) and (d)(2)(i)(B) of this section.

Example 2. Section 338 election. P owns all of the stock of S and no other assets. X acquires all of the P stock from the P shareholders and makes an

election under section 338. Under section 355(d)(5)(A), X has acquired the P stock by purchase. Under section 338(a) and (b), P is treated as having sold all of its assets at fair market value and purchased the assets as a new corporation as of the beginning of the day after the acquisition date for an amount equal to the purchase price of the P stock. Accordingly, P is treated as having purchased all of the S stock under section 355(d)(5)(A).

(2) *Exceptions to definition of purchase under section 355(d)(5)(A).* The following acquisitions are not treated as purchases under section 355(d)(5)(A):

(i) *Acquisition of stock in a transaction which includes other property or money—*

(A) *Transferors and shareholders of transferor or distributing corporations—(1) In general.* An acquisition of stock permitted to be received by a transferor of property without the recognition of gain under section 351(a), or permitted to be received without the recognition of gain under section 354 or 355, is not a purchase to the extent section 358(a)(1) applies to determine the recipient's basis in the stock received, whether or not the recipient also recognizes gain under section 351(b) or 356. But see paragraph (e)(3) of this section (interest received in exchange for purchased interest in exchanged basis transaction treated as purchased).

(2) *Exception.* To the extent there is received in the exchange or distribution, in addition to stock described in paragraph (d)(2)(i)(A)(I) of this section, stock that is other property under section 351(b) or 356(a)(1), the stock is treated as purchased on the date of the exchange or distribution for purposes of section 355(d).

(B) *Transferee corporations—(1) In general.* An acquisition of stock by a corporation is not a purchase to the extent section 334(b) or 362(a) or (b) applies to determine the corporation's basis in the stock received. But see section 355(d)(5)(C) and paragraph (e)(2) of this section (purchased property transferred in transferred basis transaction is treated as purchased by transferee).

(2) *Exception.* If a corporation acquires stock, the stock is treated as purchased on the date of the stock acquisition for purposes of section 355(d)—

(i) If the liquidating corporation recognizes gain or loss with respect to the transferred stock as described in section 334(b)(1); or

(ii) To the extent the basis of the transferred stock is increased through the

recognition of gain by the transferor under section 362(a) or (b).

(C) *Examples.* The following examples illustrate this paragraph (d)(2)(i):

Example 1. (i) A owns all the stock of T. T merges into D in a transaction qualifying under section 368(a)(1)(A), with A exchanging all of the T stock for D stock and \$100 cash. Under section 356(a)(1), A recognizes \$100 of the realized gain on the transaction. Under section 358(a)(1), A's basis in the D stock equals A's basis in the T stock, decreased by the \$100 received and increased by the gain recognized, also \$100. Under paragraph (d)(2)(i)(A) of this section, A is not treated as having purchased the D stock for purposes of section 355(d)(5).

(ii) The facts are the same as in paragraph (i) of this *Example*, except that rather than D stock and \$100 cash, A receives D stock and stock in C, a corporation not a party to the reorganization, with a fair market value of \$100. Under section 358(a)(2), A's basis in the C stock is its fair market value, or \$100. Under paragraph (d)(2)(i)(A)(2) of this section, A is treated as having purchased the C stock, but not the D stock, for purposes of section 355(d)(5).

Example 2. A purchases all of the stock of D, which is not marketable stock, on Date 1 for \$90. Within five years of A's purchase, on Date 2, A contributes the D stock to P in exchange for P stock worth \$90 and \$10 cash in a transaction qualifying under section 351. Under section 362(a), P's basis in D is \$100. P is treated as having purchased 90 percent (\$90 worth) of the D stock on Date 1 under section 355(d)(5)(C) and paragraph (e)(2)(i) of this section and as having purchased 10 percent (\$10 worth) of the D stock on Date 2 under paragraph (d)(2)(i)(B)(2) of this section.

(ii) *Acquisition of stock in a distribution to which section 305(a) applies.* An acquisition of stock in a distribution qualifying under section 305(a) is not a purchase to the extent section 307(a) applies to determine the recipient's basis. However, to the extent the distribution is of rights to acquire stock, see paragraph (c)(3) of this section for rules regarding options, warrants, convertible obligations, and other similar interests.

(iii) *Section 1036(a) exchange.* An exchange of stock qualifying under section 1036(a) is not a purchase by either party to the exchange to the extent the basis of the property acquired equals that of the property exchanged under section 1031(d).

(3) *Certain section 351 exchanges treated as purchases—(i) In general—(A) Treatment of stock received by transferor.* Under section 355(d)(5)(B), a purchase includes any acquisition of property in an exchange to which section 351 applies to the extent the property is acquired in exchange for any cash or cash item, any

marketable stock, or any debt of the transferor. The property treated as acquired by purchase is the property received by the transferor in the exchange.

(B) *Multiple classes of stock.* If the transferor in a transaction described in section 355(d)(5)(B) receives stock or securities of more than one class, or receives both stock and securities, then the amount of stock or securities purchased is determined in a manner that corresponds to the allocation of basis to the stock or securities under section 358. See §1.358-2(b).

(ii) *Cash item, marketable stock.* For purposes of section 355(d)(5)(B) and this paragraph (d)(3), either or both of the terms *cash item* and *marketable stock* include personal property within the meaning of section 1092(d)(1) and §1.1092(d)-1, without giving effect to section 1092(d)(3).

(iii) *Exception for certain acquisitions—(A) In general.* Except to the extent provided in paragraph (e)(3) of this section (interest received in exchange for purchased interest in exchanged basis transaction treated as purchased), an acquisition of stock in a corporation in a section 351 transaction by one or more persons in exchange for an amount of stock in another corporation (the transferred corporation) that meets the requirements of section 1504(a)(2) is not a purchase by the transferor or transferors, regardless of whether the stock of the transferred corporation is marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section.

(B) *Example.* The following example illustrates this paragraph (d)(3)(iii):

Example. D's two classes of stock, voting common and nonvoting preferred, are both widely held and publicly traded. The nonvoting preferred stock is stock described in section 1504(a)(4). Assume that all of the D stock is marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section. D's board of directors proposes that, for valid business purposes, D's common stock should be held by a holding company, HC, but its preferred stock should not be transferred to HC. As proposed, the D common shareholders exchange their D stock solely for HC common stock in a section 351(a) transaction. The D preferred shareholders retain their stock. HC acquires an amount of D stock that meets the requirements of section 1504(a)(2). Although the D common stock was marketable stock in the hands of the D shareholders immediately before the transfer, and the D nonvoting preferred stock is marketable stock after the transfer, the D shareholders are not treated as having acquired the

HC stock by purchase (except to the extent the exchanged basis rule of paragraph (e)(3) of this section may apply to treat HC stock as purchased on the date the exchanged D stock was purchased).

(iv) *Exception for assets transferred as part of an active trade or business*—(A) *In general.* Except to the extent provided in paragraph (e)(3) of this section, an acquisition not described in paragraph (d)(3)(iii) of this section of stock in exchange for any cash or cash item, any marketable stock, or any debt of the transferor in a section 351 transaction is not a purchase if—

(1) The transferor is engaged in the active conduct of a trade or business under paragraph (d)(3)(iv)(B) of this section and the transferred items (including debt incurred in the ordinary course of the trade or business) are used in the trade or business;

(2) The transferred items do not exceed the reasonable needs of the trade or business under paragraph (d)(3)(iv)(C) of this section;

(3) The transferor transfers the items as part of the trade or business; and

(4) The transferee continues the active conduct of the trade or business.

(B) *Active conduct of a trade or business.* For purposes of this paragraph (d)(3)(iv), whether, with respect to the trade or business at issue, the transferor and transferee are engaged in the active conduct of a trade or business is determined under §1.355-3(b)(2) and (3), except that—

(1) Conduct is tested before the transfer (with respect to the transferor) and after the transfer (with respect to the transferee) rather than immediately after a distribution; and

(2) The trade or business need not have been conducted for five years before its transfer, but it must have been conducted for a sufficient period of time to establish that it is a viable and ongoing trade or business.

(C) *Reasonable needs of the trade or business.* For purposes of this paragraph (d)(3)(iv), the reasonable needs of the trade or business include only the amount of cash or cash items, marketable stock, or debt of the transferor that a prudent business person apprised of all relevant facts would consider necessary for the present and reasonably anticipated future needs of the business. Transferred items may be considered necessary for reason-

ably anticipated future needs only if the transferor and transferee have specific, definite, and feasible plans for their use. Those plans must require that items intended for anticipated future needs rather than present needs be used as expeditiously as possible consistent with the business purpose for retention of the items. Future needs are not reasonably anticipated if they are uncertain or vague or where the execution of the plan for their use is substantially postponed. The reasonable needs of a trade or business are generally its needs at the time of the transfer of the business including the items. However, for purposes of applying section 355(d) to a distribution, events and conditions after the transfer and through the date immediately after the distribution (including whether plans for the use of transferred items have been consummated or substantially postponed) may be considered to determine whether at the time of the transfer the items were necessary for the present and reasonably anticipated future needs of the business.

(D) *Consideration of all facts and circumstances.* All facts and circumstances are considered in determining whether this paragraph (d)(3)(iv) applies.

(v) *Exception for transfer between members of the same affiliated group*—

(A) *In general.* Except to the extent provided in paragraph (e)(3) of this section, an acquisition of stock (whether actual or constructive) not described in paragraphs (d)(3)(iii) and (iv) of this section in exchange for any cash or cash item, marketable stock, or debt of the transferor in a section 351 transaction is not a purchase if the transferor corporation or corporations, the transferee corporation, and any distributed controlled corporation of the transferee corporation are members of the same affiliated group as defined in section 1504(a) before the section 351 transaction (if the transferee corporation is in existence before the transaction) and do not cease to be members of such affiliated group in any transaction that is related to the section 351 transaction (including any distribution of a controlled corporation by the transferee corporation). But see paragraph (b)(4) of this section where the transfer is made for a principal purpose to avoid the purposes of section 355(d).

(B) *Examples.* The following examples illustrate this paragraph (d)(3)(v):

Example 1. Publicly traded P has wholly owned S since 1990. S is engaged in the business of computer software development and is developing a new software platform for use in the managed health care industry. Over a period of four years beginning on January 31, 2000, P contributes a substantial amount of cash to S solely for the purpose of funding the software platform development. On completion of the software platform in January of 2004, 60 percent of the value of the S stock is attributable to the cash contributions made within the last four years. The P group's primary lender requires that S separately incorporate the software platform and related assets and distribute the new subsidiary to P as a condition of providing required funding to market the platform. Accordingly, on February 1, 2004, S forms N, contributes the platform and related assets to N, and distributes all of the N stock to P in a transaction intended to qualify under section 355(a). P, S, and N will not leave the affiliated group in any transaction related to the cash contributions. Under paragraph (d)(3)(v)(A) of this section, P's cash contributions to S are not treated as purchases of additional S stock, and the distribution of N from S to P is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. On Date 1, P contributes cash to its subsidiary S with a principal purpose to increase its stock basis in S. Sixty percent of the value of P's S stock is attributable to the cash contribution. Under paragraph (b)(4) of this section (anti-avoidance rule), 60 percent of the S stock is treated as purchased under section 355(d)(5)(B), notwithstanding paragraph (d)(3)(v)(A) of this section. Accordingly, any distribution of a subsidiary of S to P within the five-year period after Date 1 will be a disqualified distribution, regardless of whether P, S, and any distributed S subsidiary remain affiliated after the distribution and any transactions related to the cash contribution.

(4) *Triangular asset reorganizations*—
(i) *Definition.* A triangular asset reorganization is a reorganization that qualifies under—

(A) Section 368(a)(1)(A) or (G) by reason of section 368(a)(2)(D);

(B) Section 368(a)(1)(A) by reason of section 368(a)(2)(E) (regardless of whether section 368(a)(3)(E) applies), unless the transaction also qualifies as either a section 351 transfer or a reorganization under section 368(a)(1)(B); or

(C) Section 368(a)(1)(C), and stock of the controlling corporation rather than the acquiring corporation is exchanged for the acquired corporation's properties.

(ii) *Treatment.* Notwithstanding section 355(d)(5)(A), for purposes of section 355(d), the controlling corporation in a triangular asset reorganization is treated as having—

(A) Acquired the assets of the acquired corporation (and as having assumed any liabilities assumed by the controlling cor-

poration's subsidiary corporation or to which the acquired corporation's assets were subject (the acquired liabilities)) in a transaction in which the controlling corporation's basis in the acquired corporation's assets was determined under section 362(b); and

(B) Transferred the acquired assets and acquired liabilities to its subsidiary corporation in a section 351 transfer.

(iii) *Example.* The following example illustrates this paragraph (d)(4):

Example. Forward triangular reorganization. P forms S with \$10 cash and T merges into S in a reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(D) in which the T shareholders receive solely P stock in exchange for their T stock. T is not a common parent of a consolidated group of corporations. The \$10 cash with which P formed S will not be used in the acquired business. T's assets consist only of assets part of and used in its business with a value of \$80, and \$10 cash that is not part of or used in T's business. T has no liabilities. S will use T's business assets in T's business (which will become S's business), but will invest the \$20 cash in an unrelated passive investment. Under paragraph (d)(4)(ii) of this section, P is treated as acquiring the T assets in a transaction in which P's basis in the T assets was determined under section 362(b) and contributing them to S in a section 351 transfer. The exception in paragraph (d)(3)(v) of this section does not apply because P and S became affiliated in the same transaction in which the section 351 transfer is deemed to occur. Accordingly, P is treated under section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section as having purchased \$20 of the S stock, but is not deemed to have purchased the remaining \$80 of the S stock.

(5) *Reverse triangular reorganizations other than triangular asset reorganizations—(i) In general.* Except as provided in paragraph (d)(5)(ii) of this section, if a transaction qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) and also as either a reorganization under section 368(a)(1)(B) or a section 351 transfer, then either section 355(d)(5)(B) (and paragraph (d)(3)(i) through (iv) of this section) or 355(d)(5)(C) (and paragraph (e)(2) of this section) applies. Regardless of which method the controlling corporation employs to determine its basis in the surviving corporation stock under §1.358-6(c)(2)(ii) or 1.1502-30(b), the total amount of surviving corporation stock treated as purchased by the controlling corporation will equal the higher of—

(A) The amount of surviving corporation stock that would be treated as purchased (on the date of the deemed section

351 transfer) by the controlling corporation if the controlling corporation acquired the surviving corporation's assets and assumed its liabilities in a transaction in which the controlling corporation's basis in the surviving corporation assets was determined under section 362(b), and then transferred the acquired assets and liabilities to the surviving corporation in a section 351 transfer (see §§1.358-6(c)(1) and (2)(ii)(A) and 1.1502-30(b)); or

(B) The amount of surviving corporation stock that would be treated as purchased (on the date the surviving corporation shareholders purchased their surviving corporation stock) if the controlling corporation acquired the stock of the surviving corporation in a transaction in which the basis in the surviving corporation's stock was determined under section 362(b) (see §§1.358-6(c)(2)(ii)(B) and 1.1502-30(b)).

(ii) *Letter ruling and closing agreement.* If a controlling corporation obtains a letter ruling and enters into a closing agreement under section 7121 in which it agrees to determine its basis in surviving corporation stock under §1.358-6(c)(2)(ii)(A), or under §1.1502-30(b) by applying §1.358-6(c)(2)(ii)(A) (deemed asset acquisition and transfer by controlling corporation), then section 355(d)(5)(B) and paragraph (d)(3)(i) through (iv) of this section apply, and section 355(d)(5)(C) and paragraph (e)(2) of this section do not apply. If a controlling corporation obtains a letter ruling and enters into a closing agreement under section 7121 under which it agrees to determine its basis in surviving corporation stock under §1.358-6(c)(2)(ii)(B), or under §1.1502-30(b) by applying §1.358-6(c)(2)(ii)(B) (deemed stock acquisition), then section 355(d)(5)(C) and paragraph (e)(2) of this section apply, and section 355(d)(5)(B) and paragraphs (d)(3)(i) through (iv) of this section do not apply.

(iii) *Example.* The following example illustrates this paragraph (d)(5):

Example. Reverse triangular reorganization; purchase. (i) A purchases 60 percent of the stock of D on Date 1. D owns no cash items, marketable stock, or transferor debt, but holds cash that is not part of or used in D's trade or business under paragraph (d)(3)(iv) of this section and that represents 20 percent of D's value. On Date 2, P forms S, and S merges into D in a reorganization qualifying under section 368(a)(1)(B) and under section 368(a)(1)(A) by reason of section 368(a)(2)(E). In the reorganiza-

tion, P acquires all of the D stock in exchange solely for P stock. After Date 2, and within five years after Date 1, D distributes its wholly owned subsidiary C to P. P does not obtain a letter ruling and enter into a closing agreement under paragraph (d)(5)(ii) of this section. P would acquire 20 percent of the D stock by purchase on Date 2 under paragraph (d)(5)(i)(A) of this section by operation of section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section. The exception in paragraph (d)(3)(v) of this section does not apply because P and S became affiliated in the same transaction in which the section 351 transfer is deemed to occur. P would acquire 60 percent of the D stock by purchase on Date 1 under paragraph (d)(5)(i)(B) of this section because, under the transferred basis rule of section 355(d)(5)(C) and paragraph (e)(2) of this section, P is treated as though P purchased the D stock on the date A purchased it. Accordingly, under paragraph (d)(5)(i) of this section, P is treated as acquiring the higher amount (60 percent) by purchase on Date 1. D's distribution of C to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section. In addition, A is treated as acquiring the P stock by purchase on Date 1 under paragraph (e)(3) of this section because A's basis in the P stock is determined by reference to A's basis in the D stock.

(ii) The facts are the same as in paragraph (i) of this *Example*, except that P obtains a letter ruling and enters into a closing agreement under which it agrees to determine its basis in the D stock under §1.358-6(c)(2)(ii)(A). Under paragraph (d)(5)(ii) of this section, section 355(d)(5)(B) (and paragraphs (d)(3)(i) through (iv) of this section) applies, and section 355(d)(5)(C) (and paragraph (e)(2) of this section) does not apply. Accordingly, P is treated as acquiring only 20 percent of the D stock by purchase on Date 2. D's distribution of C to P is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

(6) *Treatment of group structure changes—(i) In general.* Notwithstanding section 355(d)(5)(A), for purposes of section 355(d), if a corporation succeeds another corporation as the common parent of a consolidated group in a group structure change to which §1.1502-31 applies, the new common parent is treated as having acquired the assets and assumed the liabilities of the former common parent in a transaction in which the new common parent's basis in the former common parent's assets was determined under section 362(b), and then transferred the acquired assets and liabilities to the former common parent (or, if the former common parent does not survive, to the new common parent's subsidiary) in a section 351 transfer, with the new common parent and former common parent being treated as not in the same affiliated group at the time of the transfer (notwithstanding §1.1502-31(c)(2)).

(ii) *Adjustments to basis of higher-tier members.* A higher-tier member that indirectly owns all or part of the former common parent's stock after a group structure change is treated as having purchased the stock of an immediate subsidiary to the extent that the higher-tier member's basis in the subsidiary is increased under §1.1502-31(d)(4).

(iii) *Example.* The following example illustrates this paragraph (d)(6):

Example. P is the common parent of a consolidated group, and T is the common parent of another group. P has owned S for more than five years, and the fair market value of the S stock is \$50. T's assets consist only of non-marketable stock of direct and indirect wholly owned subsidiaries with a value of \$50, assets used in its business with a value of \$50, and \$50 of marketable stock that is not part of or used in T's business. T has no liabilities. T merges into S with the T shareholders receiving solely P stock with a value of \$150 in exchange for their T stock in a section 368(a)(2)(D) reorganization. S will use T's business assets in T's business (which will become S's business), but will hold the \$50 of marketable stock for investment purposes. Assume that the transaction is a reverse acquisition under §1.1502-75(d)(3) because the T shareholders, as a result of owning T stock, own more than 50 percent of the value of P's stock immediately after the transaction. Thus, the transaction is a group structure change under §1.1502-33(f)(1). Under paragraph (d)(6) of this section, P is treated as having acquired the assets of T in a transaction in which P's basis in the T assets was determined under section 362(b), and then transferred the acquired assets to S in a section 351 transfer, with P and T being treated as not in the same affiliated group at the time of the transfer. The exception in paragraph (d)(3)(v) of this section (transfers within an affiliated group) does not apply. Accordingly, P is treated under section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section as having purchased \$50 of the S stock (attributable to the marketable stock), but is not deemed to have purchased the remaining \$150 of the S stock.

(7) *Special rules for triangular asset reorganizations, other reverse triangular reorganizations, and group structure changes.* The amount of acquiring subsidiary, surviving corporation, or former common parent stock that is treated as purchased under paragraph (c)(4), (5)(i)(A), or (6) of this section (by operation of section 355(d)(5)(B) and paragraphs (d)(3)(i) through (iv) of this section) is adjusted to reflect any basis adjustment under—

(i) Section 1.358-6(c)(2)(i)(B) and (C) (reduction of basis adjustment in reverse triangular reorganization where controlling corporation acquires less than all of the surviving corporation stock),

§1.1502-30(b) (applying §1.358-6(c)-(2)(i)(B) and (C) to a consolidated group), and §1.1502-31(d)(2)(ii) (reduction of basis adjustment in group structure change where new common parent acquires less than all of the former common parent stock); or

(ii) Section 1.358-6(d) (reduction of basis adjustment in any triangular reorganization to the extent controlling corporation does not provide consideration), §1.1502-30(b) (applying §1.358-6(d) (except §1.358-6(d)(2)) to a consolidated group), and §1.1502-31(d)(1) (reduction of basis adjustment in group structure change to the extent new common parent does not provide consideration).

(e) *Deemed purchase and timing rules—(1) Attribution and aggregation—(i) In general.* Under section 355(d)-(8)(B), if any person acquires by purchase an interest in any entity, and the person is treated under section 355(d)(8)(A) as holding any stock by reason of holding the interest, the stock shall be treated as acquired by purchase on the later of the date of the purchase of the interest in the entity or the date the stock is acquired by purchase by such entity.

(ii) *Purchase of additional interest.* If a person and an entity are treated as a single person under section 355(d)(7), and the person later purchases an additional interest in the entity, the person is treated as purchasing on the date of the later purchase the amount of stock attributed from the entity to the person under section 355(d)(8)(A) as a result of the additional interest.

(iii) *Purchase between persons treated as one person.* If two persons are treated as one person under section 355(d)(7), and one later purchases stock or securities from the other, the date of the later purchase is used for purposes of determining when the five-year period commences.

(iv) *Purchase by a person already treated as holding stock under section 355(d)(8)(A).* If a person who is already treated as holding stock under section 355(d)(8)(A) later directly purchases such stock, the date of the later direct purchase is used for purposes of determining when the five-year period commences.

(v) *Examples.* The following examples illustrate this paragraph (e)(1):

Example 1. On Date 1, A purchases 10 percent of the stock of P, which has held 100 percent of the

stock of T for more than five years at the time of A's purchase. A is deemed to have purchased 10 percent of P's T stock on Date 1. If A later purchases an additional 41 percent of the stock of P on Date 2, A is deemed to have purchased an additional 41 percent of P's T stock on Date 2. Because A and P are now related persons under section 267(b), they are treated as one person under section 355(d)(7)(A), and A is treated as owning all of P's T stock. A is treated as acquiring 51 percent of the T stock by purchase at the times of A's respective purchases of P stock on Date 1 and Date 2. The remaining 49 percent of T stock is treated as acquired when P acquired the T stock, more than five years before Date 1. If P distributes T within five years after Date 1, the distribution will be a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. A has owned 60 percent of the stock of P for more than five years, and P has owned 40 percent of the stock of T for more than five years. A and P are treated as one person, and A is treated as owning 40 percent of the stock of T for more than five years. If P later purchases an additional 20 percent of the stock of T on Date 1, A is treated as acquiring by purchase the additional 20 percent of T stock on Date 1. If A then purchases an additional 10 percent of the stock of P on Date 2, under the attribution rule and the deemed purchase rule, A is deemed to have purchased on Date 2 an additional four percent of the T stock (10 percent of the 40 percent that P originally owned). In addition, even though A and P were already treated as one person under section 355(d)(7)(A), A is also deemed to have purchased two percent of the T stock on Date 2 (10 percent of the 20 percent of the T stock that it was treated as purchasing on Date 1). A is still treated as owning all 60 percent of the T stock owned by P. However, of the 60 percent, A is treated as having purchased 18 percent of the T stock on Date 1 and 6 percent of the T stock on Date 2, for a total of 24 percent purchased stock.

Example 3. A purchases a 20 percent interest in partnership M on Date 1. M has owned 30 percent of the stock and 25 percent of the securities of P for more than five years. P has owned 40 percent of the stock and 100 percent of the securities of T for more than five years. Under section 318(a)(2)(C) as modified by section 355(d)(8)(A), M is deemed to own 12 percent of the stock (30 percent of the 40 percent P owns) and 30 percent of the securities (30 percent of the 100 percent P owns) of T. Under sections 318(a)(2)(A) and 355(d)(8)(B), A is deemed to have purchased 2.4 percent of the stock (20 percent of the 12 percent M is deemed to own) and 6 percent of the securities (20 percent of the 30 percent M is deemed to own) of T on Date 1. Similarly, A is deemed to have purchased 6 percent of the stock (20 percent of the 30 percent M owns) and five percent of the securities (20 percent of the 25 percent M owns) of P on Date 1. If M later purchases an additional 10 percent of P stock on Date 2, M is deemed to have purchased four percent of the stock (10 percent of the 40 percent P owns) and 10 percent of the securities (10 percent of the 100 percent P owns) of T on Date 2. A is deemed to have purchased two percent of the stock of P on Date 2 (20 percent of the 10 percent M purchased). A is also deemed to have purchased 0.8 percent of the stock (20 percent of the four percent M is deemed to have purchased) and two percent of

the securities (20 percent of the 10 percent M is deemed to have purchased) of T on Date 2.

Example 4. A and B are brother and sister. For more than five years, A has owned 75 percent of the stock of P, and B has owned 25 percent of the stock of P. A and B are treated as one person under section 267(b), and the stock of each is treated as purchased on the date it was purchased by A and B, respectively. If B later purchases 50 percent of the P stock from A on Date 1, A and B are still treated as one person. However, the 50 percent of P stock that B purchased from A is treated as purchased on Date 1.

(2) *Transferred basis rule.* If any person acquires property from another person who acquired the property by purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section, but without regard to section 355(d)(8) and paragraph (e)(1) of this section), and the adjusted basis of the property in the hands of the acquirer is determined in whole or in part by reference to the adjusted basis of the property in the hands of the other person, the acquirer is treated as having acquired the property by purchase on the date it was so acquired by the other person. The rule in this paragraph (e)(2) applies, for example, where stock of a corporation acquired by purchase is subsequently acquired in a section 351 transfer or a reorganization qualifying under section 368(a)(1)(B), but does not apply if the stock of a former common parent is acquired in a group structure change to which §1.1502-31 applies. But see paragraph (d)(2)(i)(B)(2) of this section for situations where the stock is treated as purchased on the date of a transfer.

(3) *Exchanged basis rule—(i) In general.* If any person acquires an interest in an entity (the first interest) by purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section, but without regard to section 355(d)(8) and paragraph (e)(1) of this section), and the first interest is exchanged for an interest in another entity (the second interest) where the adjusted basis of the second interest is determined in whole or in part by reference to the adjusted basis of the first interest, then the second interest is treated as having been purchased on the date the first interest was purchased. The rule in this paragraph (e)(3) applies, for example, where stock of a corporation acquired by purchase is subsequently exchanged for other stock in a section 351, 354, or 1036(a) exchange.

But see paragraph (d)(2)(i)(A)(2) of this section for situations where the stock is treated as purchased on the date of an exchange or distribution.

(ii) *Example.* The following example illustrates this paragraph (e)(3):

Example. A purchases 50 percent of the stock of T on Date 1. On Date 2, T merges into D in a section 368(a)(1)(A) reorganization, with A exchanging all of the T stock solely for stock of D. Under section 358(a), A's basis in the D stock is determined by reference to the basis of the T stock it purchased. Accordingly, A is treated as having purchased the D stock on Date 1, and has a purchased basis in the D stock under paragraph (b)(3)(iii) of this section.

(4) *Substantial diminution of risk—(i) In general.* If section 355(d)(6) applies to any stock for any period, the running of any five-year period set forth in section 355(d)(3) is suspended during such period.

(ii) *Property to which suspension applies.* Section 355(d)(6) applies to any stock for any period during which the holder's risk of loss with respect to such stock, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by an option, a short sale, any special class of stock, or any other device or transaction.

(iii) *Risk of loss substantially diminished.* Whether a holder's risk of loss is substantially diminished under section 355(d)(6) and paragraph (e)(4)(ii) of this section will be determined based on all facts and circumstances relating to the stock, the corporate activities, and arrangements for holding the stock.

(iv) *Special class of stock.* For purposes of section 355(d)(6) and paragraph (e)(4)(ii) of this section, the term *special class of stock* includes a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to the earnings, assets, or attributes of less than all the assets or activities of a corporation or any of its subsidiaries. The term includes, for example, tracking stock and stock (or any related instruments or arrangements) the terms of which provide for the distribution (whether or not at the option of any party or in the event of any contingency) of any controlled corporation or other specified assets to the holder or to one or more persons other than the holder.

(f) *Duty to determine stockholders—(1) In general.* In determining whether section 355(d) applies to a distribution of

controlled corporation stock, a distributing corporation must determine whether a disqualified person holds its stock or the stock of any distributed controlled corporation. This paragraph (f) provides rules regarding this determination and the extent to which a distributing corporation must investigate whether a disqualified person holds stock.

(2) *Deemed knowledge of contents of securities filings.* A distributing corporation is deemed to have knowledge of the existence and contents of all schedules, forms, and other documents filed with or under the rules of the Securities and Exchange Commission, including without limitation any Schedule 13D or 13G (or any similar schedules) and amendments, with respect to any relevant corporation.

(3) *Presumption as to securities filings.* Absent actual knowledge to the contrary, in determining whether section 355(d) applies to a distribution, a distributing corporation may presume, with respect to stock that is reporting stock (while such stock is reporting stock), that every shareholder or other person required to file a schedule, form, or other document with or under the rules of the Securities and Exchange Commission as of a given date has filed the schedule, form, or other document as of that date and that the contents of filed schedules, forms, or other documents are accurate and complete. *Reporting stock* is stock that is described in Rule 13d-1(i) of Regulation 13D (17 CFR 240.13d-1(i)) (or any rule or regulation to generally the same effect) promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

(4) *Presumption as to less-than-five-percent shareholders.* Absent actual knowledge (or deemed knowledge under paragraph (f)(2) of this section) immediately after the distribution to the contrary with regard to a particular shareholder, a distributing corporation may presume that no less-than-five-percent shareholder of a corporation acquired stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period. For purposes of this paragraph (f), a less-than-five-percent shareholder is a person that, at no time during the five-year period, holds directly (or by application of paragraph (c)(3)(ii) of this section, but not by application of section 355(d)(7) or (8))

stock possessing five percent or more of the total combined voting power of all classes of stock entitled to vote and the total value of shares of all classes of stock of a corporation. However, this presumption does not apply to any less-than-five-percent shareholder that, at any time during the five-year period —

(I) Is related under section 355(d)(7)(A) to a shareholder in the corporation that is, at any time during the five-year period, not a less-than-five-percent shareholder;

(ii) Acted pursuant to a plan or arrangement, with respect to acquisitions of the corporation's stock under section 355(d)(7)(B) and paragraph (c)(4) of this section, with a shareholder in the corporation that is, at any time during the five-year period, not a less-than-five-percent shareholder; or

(iii) Holds stock that is attributed under section 355(d)(8)(A) to a shareholder in the corporation that is, at any time during the five-year period, not a less-than-five-percent shareholder.

(5) *Examples.* The following examples illustrate this paragraph (f):

Example 1. Publicly traded corporation; no schedules filed. D is a widely held and publicly traded corporation with a single class of reporting stock and no other class of stock. Assume that applicable federal law requires any person that directly holds five percent or more of the D stock to file a schedule with the Securities and Exchange Commission within 10 days after an acquisition. D distributes its wholly owned subsidiary C pro rata. D determines that no schedule, form, or other document has been filed with respect to its stock or the stock of any other relevant corporation during the five-year period or within 10 days after the distribution. Immediately after the distribution, D has no knowledge that any of its shareholders are (or were at any time during the five-year period) not less-than-five-percent shareholders, or that any particular shareholder acquired D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period. Under paragraph (f)(3) of this section, D may presume it has no shareholder that is or was not a less-than-five-percent shareholder during the five-year period due to the absence of any filed schedules, forms, or other documents. Under paragraph (f)(4) of this section, D may presume that none of its less-than-five-percent shareholders acquired D's stock by purchase during the five-year period. Accordingly, D may presume that section 355(d) does not apply to the distribution of C.

Example 2. Publicly traded corporation; schedule filed. The facts are the same as those in *Example 1*, except that D determines that, as of 10 days after the distribution, only one schedule has been filed with respect to its stock. That schedule discloses that X acquired 15 percent of the D stock one year

before the distribution. Absent contrary knowledge, D may rely on the presumptions in paragraph (f)(3) of this section and so may presume that X is its only shareholder that is or was not a less-than-five-percent shareholder during the five-year period. D may not rely on the presumption in paragraph (f)(4) of this section with respect to X. In addition, D may not rely on the presumption in paragraph (f)(4) of this section with respect to any less-than-five-percent shareholder that, at any time during the five-year period, is related to X under section 355(d)(7)(A), acted pursuant to a plan or arrangement with X under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to X under section 355(d)(8)(A). Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: whether X acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether X is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether X is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

Example 3. Acquisition of publicly traded corporation. The facts are the same as those in *Example 1*, except that P acquires all of the D stock in a section 368(a)(1)(B) reorganization that is not also a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E), and D distributes C to P one year later. Under the deemed purchase rule of section 355(d)(5)(C) and paragraph (e)(2) of this section, P is treated as having acquired the D stock by purchase on the date the D shareholders acquired the D stock by purchase. Even though D has no less-than-five-percent shareholder immediately after the distribution, D may rely on the presumptions in paragraphs (f)(3) and (4) of this section to determine whether and to what extent the D stock is treated as purchased during the five-year period in P's hands under the deemed purchase rule of section 355(d)(5)(C) and paragraph (e)(2) of this section. Accordingly, D may presume that section 355(d) does not apply to the distribution of C to P.

Example 4. Non-publicly traded corporation. D is owned by 20 shareholders and has a single class of stock that is not reporting stock. D knows that A owns 40 percent of the D stock, and D does not know that any other shareholder has owned as much as five percent of the D stock at any time during the five-year period. D may not rely on the presumption in paragraph (f)(3) of this section because its stock is not reporting stock. D may not rely on the presumption in paragraph (f)(4) of this section with respect to A. In addition, D may not rely on the presumption in paragraph (f)(4) of this section for any less-than-five-percent shareholder that, at any time during the five-year period, is related to A under section 355(d)(7)(A), acted pursuant to a plan or arrangement with A under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to A under section 355(d)(8)(A). D may rely on the pre-

sumption in paragraph (f)(4) of this section for less-than-five-percent shareholders that during the five-year period are not related to A, did not act pursuant to a plan or arrangement with A, and do not hold stock attributed to A. Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: that A is its only shareholder that is (or was at any time during the five-year period) not a less-than-five-percent shareholder; whether A acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether A is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether A is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

(g) *Effective date.* This section applies to distributions occurring after these regulations are published as final regulations in the **Federal Register**, except that they do not apply to any distributions occurring pursuant to a written agreement which is (subject to customary conditions) binding on the date the regulations in this section are published as final regulations in the **Federal Register**, and at all times thereafter.

Robert E. Wenzel,
Deputy Commissioner of
Internal Revenue.

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