

Notice of Proposed Rulemaking and Notice of Public Hearing

Redemptions Taxable as Dividends

REG-150313-01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide guidance regarding the treatment of the basis of redeemed stock when a distribution in redemption of such stock is treated as a dividend, as well as guidance regarding certain acquisitions of stock by related corporations that are treated as distributions in redemption of stock. The proposed regulations affect shareholders whose stock in a corporation is redeemed or is acquired by a corporation related to the issuer of the stock, and are necessary to provide such shareholders with guidance regarding the treatment of the basis of such stock. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 16, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for February 20, 2003, at 10 a.m. must be received by January 30, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-150313-01), 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:ITA:RU (REG-150313-01), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue,

NW, Washington, DC 20224. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations generally, Lisa K. Leong, (202) 622-7530; concerning issues under sections 367, 861 and 864 of the Internal Revenue Code, Aaron A. Farmer, (202) 622-3860; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena V. Garrett, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by December 17, 2002. Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

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

The collection of information in these proposed regulations is in § 1.302-5(e) and § 1.1502-19(b)(5)(v). This collection of information is required by the IRS to verify compliance with section 302. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to properly determine the amount permitted to be taken into account as a loss. The respondents are shareholders (including individuals, corporations and pass-through entities) whose stock in a corporation is redeemed or is treated as redeemed.

Estimated total annual reporting burden: 1,500 hours.

Estimated average annual burden per respondent: 30 minutes.

Estimated number of respondents: 3,000.

Estimated annual frequency of responses: On occasion.

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

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed revisions and amendments to the Income Tax Regulations (26 CFR part 1) under sections 302, 304, 704, 861, 1371, 1374, and 1502 of the Internal Revenue Code (Code). The proposed regulations would amend the temporary and final regulations under sections 302, 304, 704, 861, 1371, 1374, and 1502 to provide guidance concerning the treatment of the basis of stock redeemed or treated as redeemed where the redemption proceeds are treated as a dividend distribution. These proposed regulations would also amend the final regulations under section 304 to conform them to certain of the amendments made to section 304 by legislation, including section 226 of the Tax Equity and Fiscal Responsibility Act of

1982, Public Law 97-248 (96 Stat. 325, 490) (September 3, 1982), section 712(l) of the Deficit Reduction Act of 1984, Public Law 98-369 (98 Stat. 494, 953-55) (July 18, 1984), section 1875(b) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085, 2894) (October 22, 1986), and section 1013 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 918) (August 5, 1997).

A. The Character of Property Received in Redemption of Stock

Section 302 of the Code governs the tax treatment of distributions in redemption of stock. The rules of section 302 attempt to distinguish between distributions that “may have capital-gain characteristics because they are not made *pro rata* among the various shareholders” and distributions “characterized by what happens solely at the corporate level by reason of the assets distributed.” S. Rep. No. 1622, 83d Cong., 2d Sess. 49 (1954). Section 302(a) provides that a corporation’s redemption of its stock is treated as a distribution in part or full payment in exchange for the stock if the redemption satisfies any one of the following criteria: (1) the redemption is not essentially equivalent to a dividend (section 302(b)(1)); (2) the redemption is substantially disproportionate (section 302(b)(2)); (3) the redemption completely terminates the redeemed shareholder’s interest (section 302(b)(3)); or (4) the redemption is in connection with a qualifying partial liquidation (section 302(b)(4)). If a redemption satisfies none of these criteria, pursuant to section 302(d), the redemption is treated as a distribution of property to which section 301 applies.

Under sections 301(c)(1) and 316(a), a distribution is treated as a dividend to the extent of the redeeming corporation’s earnings and profits. Any portion of the distribution that is not treated as a dividend is first applied against the adjusted basis of the redeemed stock to the extent of such basis under section 301(c)(2), and then treated as gain from the sale or exchange of property under section 301(c)(3).

B. The Character of Property Received in Certain Stock Acquisitions

The redemption rules of section 302 are implicated not only when an issuing corporation acquires its own stock, but also in the case of certain stock acquisitions by cor-

porations related to the issuer of the acquired stock. Pursuant to section 304(a)(1), an acquisition of stock by a corporation from one or more persons that are in control of both the acquiring and issuing corporations is treated as if the property received in respect of the acquired stock were a distribution in redemption of the stock of the acquiring corporation. Prior to the amendments made by the Taxpayer Relief Act of 1997, section 304 provided that, to the extent that the deemed distribution was treated as a distribution to which section 301 applies, the stock acquired was treated as having been transferred by the person from whom acquired and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation. The Taxpayer Relief Act of 1997 amended section 304(a)(1) to provide that, to the extent that this deemed distribution is treated as a distribution to which section 301 applies, the shareholder and the acquiring corporation are treated as if the shareholder had transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in that transaction. Pursuant to section 304(a)(2), an acquisition of stock by a corporation controlled by the issuer of the acquired stock is treated as if the property received in respect of the acquired stock was a distribution in redemption of the stock of the issuing corporation.

For purposes of section 304, control means the ownership of stock possessing at least 50 percent of either the total combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock. The determination of the amount and source of the distribution that is treated as a dividend is made as if the property received in respect of the redeemed stock were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. Because section 304 recharacterizes certain stock acquisition transactions as redemptions of stock, transactions to which section 304 applies implicate the redemption rules of section 302.

C. The Unutilized Basis of Stock Redeemed in Certain Transactions

While sections 301 and 302 clearly set forth the character of property received in a redemption (whether actual or deemed) of stock, they do not prescribe the tax treatment of the unutilized basis of the redeemed stock or the stock treated as redeemed. In 1955, the IRS and Treasury promulgated regulations under section 302 that provide guidance in this regard in the case of an actual redemption of stock. Section 1.302-2(c) of the Income Tax Regulations states that “[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.” The regulation contains examples illustrating what constitutes a proper adjustment. In *Example 1* and *Example 3*, the redeemed shareholder actually owns stock of the redeeming corporation immediately after a redemption that is treated as a distribution of a dividend. In those cases, the basis of the shares of the redeeming corporation that the shareholder owns after the redemption is increased by the basis of the redeemed shares. *See also United States v. Davis*, 397 U.S. 301 (1970) (interpreting § 1.302-2(c) to shift the basis of redeemed stock to other shares held by the redeemed shareholder, even where those other shares are of a different class of stock than those redeemed); Rev. Rul. 66-37, 1966-1 C.B. 209 (same). In *Example 2*, although the redeemed shareholder actually owns no stock of the redeeming corporation immediately after a redemption that is treated as a distribution of a dividend, he does constructively own stock of the redeeming corporation immediately after the redemption by reason of his wife’s continuing ownership of stock of the redeeming corporation. The example concludes that the redeemed shareholder’s basis in the redeemed shares shifts to his wife’s basis in her shares of stock of the redeeming corporation.

In addition, on December 2, 1955, the IRS and Treasury promulgated §§ 1.304-2(a) and 1.304-3(a). With respect to an acquisition of stock by a related corporation (other than a subsidiary), § 1.304-2(a) provides that the transferor’s basis for his stock in the acquiring corporation is increased by the basis of the stock of the issuing corporation surrendered by him. Similarly, with

respect to an acquisition of stock by a subsidiary, § 1.304-3(a) provides that the transferor's basis in his remaining stock in the parent corporation is increased by the basis of the stock deemed redeemed by the parent corporation. The treatment of the transferor's unutilized basis in stock of the issuing corporation as a result of transactions subject to section 304(a) is the subject of Revenue Ruling 70-496, 1970-2 C.B. 74, and Revenue Ruling 71-563, 1971-2 C.B. 175.

In Revenue Ruling 70-496, a first-tier subsidiary (Y) of a parent corporation (X) sold all of its stock in a second-tier subsidiary of X (S) to another first-tier subsidiary of X (Z). The ruling concludes that the transaction is governed by sections 304(a)(1) and 302(d). Accordingly, the ruling holds that the sales proceeds constitute dividends to the extent of Z's earnings and profits and, to the extent in excess of such amount, constitute gain under section 301(c)(3). With respect to Y's basis in the sold S stock, the ruling holds that because Y had no direct stock ownership in Z before or after the sale, Y's basis in the S stock surrendered disappears and cannot be used to increase the basis of any asset of Y.

In Revenue Ruling 71-563, A, an individual, owned all the stock of X. C, A's son, owned all of the outstanding stock of Y. A sold 25 percent of its stock in X to Y for cash. The ruling states that, under section 304(a)(1), the sale is treated as a contribution by A of the stock of X to the capital of Y and a distribution to A by Y in redemption of its stock. Because the deemed redemption is governed by section 302(d), the cash received is taxable as a dividend to A under section 301(c)(1). Furthermore, the ruling reasons that, because A owns no stock in Y directly after the transaction, the basis of the X stock should be added to the basis of the remaining stock of X that A continues to own after the transaction.

The current regulatory regime preserves, and prevents the elimination of, basis in transactions subject to section 302 where a proper adjustment may be made to the basis of the remaining stock of the redeeming corporation and in transactions subject to section 304 where, immediately after the transaction, the seller owns stock of the acquiring corporation. In certain transactions, however, taxpayers have taken the position that certain adjustments are proper,

even if they shift basis from a person that is not subject to U.S. tax to a person that is subject to U.S. tax or to stock other than stock of the redeeming corporation. Notice 2001-45, 2001-2 C.B. 129, describes a type of transaction with respect to which taxpayers have taken the position that, under § 1.302-2(c), all or a portion of the basis of stock redeemed from a person that is not subject to U.S. tax or is otherwise indifferent to the Federal income tax consequences of the redemption of the stock is added to the basis of other stock in the redeeming corporation owned by a taxpayer that is subject to U.S. tax to create a loss on the disposition of the other stock. Although the IRS intends to challenge the adjustments claimed in such transactions, the IRS and Treasury believe it is desirable to revise the rules that govern accounting for unutilized basis attributable to redeemed stock to better reflect the purposes of the relevant Code provisions.

Explanation of Provisions

A. Rules Under Section 302

This notice of proposed rulemaking proposes a replacement for the "proper adjustment" regime of current § 1.302-2(c) for taking into account the unutilized basis attributable to redeemed stock in any case in which a redemption of stock is treated as a distribution of property to which section 301 applies. The rules are proposed to apply both where the redeemed shareholder actually owns no stock of the redeeming corporation immediately after the redemption (a complete redemption) and where the redeemed shareholder actually owns stock of the redeeming corporation immediately after the redemption (a partial redemption). While consideration was given to retaining the "proper adjustment" rule of current § 1.302-2(c) where only a portion of the shareholder's interest in the redeeming corporation is redeemed, the IRS and Treasury believe the two situations are similar enough to warrant the same rules, and that the rules proposed herein best carry out the purposes of section 302 even where the redeemed shareholder continues directly to own stock in the redeeming corporation because, even in that case, dividend treatment under section 302 may have resulted from shares owned by attribution rather than directly. The following paragraphs describe the proposed rules.

1. General description of the proposed rules

Certain transactions that, in form, involve the redemption of shares are economically identical or similar to distributions to shareholders that do not involve any redemption of shares. For example, if a single shareholder owns all of the stock of the redeeming corporation, the redemption of some shares from that shareholder for cash is economically indistinguishable from the mere distribution of corporate cash to the shareholder. In recognition of this, section 302 taxes these transactions as corporate distributions notwithstanding their form as redemptions. The underlying premise of section 302 is that distribution treatment is called for in these cases because, in effect, the redeemed shareholder still owns (or is treated as owning) its stock in the corporation, even if it may have turned in some physical shares.

Although section 302 does not provide any explicit guidance regarding the shareholder's basis of the shares redeemed, in deriving a regulatory regime to address the treatment of the unutilized basis of redeemed stock, it is appropriate to consider what happens when a shareholder receives a distribution and keeps its shares, because that analogy underlies distribution treatment under section 302. Because the Code does not permit basis to offset any portion of the redemption distribution that is treated as a dividend, and because such an offset is not available when a corporation distributes a dividend and the shareholder retains its shares, the redemption date is not the appropriate time to recover the unutilized basis of the redeemed stock. However, if the shareholder receives a distribution and retains its shares, it also retains its basis, which it can recover later in situations other than dividends, such as the sale of the shares. Accordingly, the unutilized basis of the redeemed stock should not disappear and should be taken into account for Federal income tax purposes at some time. In addition, any tax benefit associated with the unutilized basis of redeemed stock should remain with the taxpayer that made, or succeeded to, the investment that gave rise to the unutilized basis. Accordingly, these regulations propose that, in any case where a redemption of stock is treated as a distribution of a dividend, an amount equal to the adjusted basis of the redeemed stock is treated as a loss

recognized on the disposition of the redeemed stock on the date of the redemption. That loss is taken into account as described below.

Once the facts and circumstances that caused the redemption distribution to be treated as a distribution subject to section 301 no longer exist (*i.e.*, the redeemed shareholder has sufficiently reduced its actual and constructive ownership interest in the redeeming corporation), these regulations permit the loss attributable to the unutilized basis of redeemed stock that has not previously been taken into account to be taken into account. The first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2) or (3) if the facts and circumstances that exist on such date had existed immediately after the redemption is referred to as the “final inclusion date.” In addition, a date is the final inclusion date if there is no later date on which the redeemed shareholder could take the loss into account. For example, if the redeemed shareholder is an individual, the final inclusion date includes the date of death of such individual. If the redeemed shareholder is a corporation, the final inclusion date includes the date such corporation transfers its assets in a liquidation described in section 331. If the redeemed shareholder is a foreign corporation, the final inclusion date includes the date such corporation transfers its assets to a domestic corporation in either a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies. If the redeemed shareholder is a foreign corporation that is not a controlled foreign corporation, within the meaning of section 957(a), on the date of the redemption, the term final inclusion date includes the date such corporation transfers its assets to a controlled foreign corporation in a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies.

These proposed regulations also provide that the redeemed shareholder is permitted to take into account the loss attributable to the unutilized basis of redeemed stock when the redeemed shareholder recognizes a gain on stock of the redeeming corporation to the extent of the gain recognized. Any date on which the redeemed shareholder must take into account gain recognized pursuant to section

301(c)(3) or gain recognized on a disposition of stock of the redeeming corporation is referred to as an “accelerated loss inclusion date.” Although there can be only one final inclusion date, there can be several accelerated loss inclusion dates.

Because the loss attributable to the basis of the redeemed stock is treated as recognized on a disposition of the redeemed stock on the redemption date, the attributes (*e.g.*, character and source) of that loss are fixed on the redemption date, even if such loss is not taken into account until after the redemption date. For example, if a corporation redeems its stock from a shareholder within one year after the shareholder’s acquisition of such stock and the proceeds of the redemption are treated as a dividend distribution, the character of any amount of the loss that is taken into account is treated as short-term capital loss (assuming the redeemed shareholder held the redeemed stock as a capital asset), even if such loss is taken into account more than one year after the redeemed shareholder’s acquisition of the redeemed stock. Nonetheless, for purposes of the carryforward and carryback provisions of sections 172 and 1212, such loss is treated as a loss for the taxable year in which it is taken into account rather than for the taxable year of the stock redemption that gave rise to such loss.

Because a redemption of stock may give rise to, or increase, an excess loss account in redeemed stock where the redeemed shareholder and the redeeming corporation are members of the same consolidated group, these regulations propose rules similar to those described above where the redeemed shareholder has an excess loss account in the redeemed stock.

These proposed regulations do not apply on the redemption of stock described in section 306(c). Pursuant to section 306(a)(2), a redemption of stock described in section 306(c) is treated as a distribution of property to which section 301 applies. *Example 2* of § 1.306-1 suggests that the unutilized basis of redeemed section 306 stock is added back to the basis of the stock with respect to which the section 306 stock was distributed. The IRS and Treasury request comments on whether such treatment of the unutilized basis of redeemed section 306 stock is appropriate or whether an alternative regime should apply when such a redemption is treated as a distribution to which section 301 applies.

2. *Special issues related to certain pass-through entities*

Where stock is redeemed from a partnership and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock is treated as a current loss to the partnership on the date of the redemption. To the extent of the lesser of the amount of such distribution that is treated as a dividend and such loss that is not allocated pursuant to section 704(c) and the regulations thereunder, the dividend and the loss must be allocated in equal amounts. Such amounts must be allocated in accordance with the partners’ interests in the partnership. An allocation will be deemed to be in accordance with a partner’s interest in the partnership if the allocation is in the same proportion as the allocation of (i) the excess of the dividend income over the loss attributable to the basis of the redeemed stock, if any, (ii) the excess of the loss attributable to the basis of the redeemed stock over the dividend income, if any, or, (iii) if neither, in the same proportion as the partnership’s net taxable income or loss for the year is allocated. This rule ensures that the benefit of the loss may be realized by the person to whom the dividend income was allocated. The excess dividend or loss attributable to the basis of redeemed stock must be allocated in a manner that takes into account the requirements of section 704.

The loss attributable to the basis of redeemed stock allocated to a partner under the rules of this section is not taken into account at the partner level until the final inclusion date or an accelerated loss inclusion date, as applicable. For purposes of determining whether a particular date is the final inclusion date with respect to such a loss, if the partner is a partner of the partnership on such date, the partnership is treated as the redeemed shareholder. Otherwise, the former partner is treated as the redeemed shareholder and the determination of whether a particular date is the final inclusion date is made by comparing such former partner’s actual and constructive ownership of the redeeming corporation immediately prior to the redemption to such former partner’s actual and constructive ownership of the redeeming corporation at the end of such particular date. For purposes of determining whether a particular date is an accelerated loss inclusion date

with respect to a loss attributable to the basis of redeemed stock that is allocated to a partner from a partnership, the partner is treated as the redeemed shareholder. Similar rules are proposed to apply where stock is redeemed from an S corporation.

The proposed regulations provide that where stock is redeemed from a C corporation, and the C corporation subsequently elects to be taxed as an S corporation, any loss attributable to the basis of redeemed stock that has not been taken into account at the time of the election is treated as a carryforward arising in a taxable year for which the corporation was a C corporation. Such loss is allowed as a deduction against net recognized built-in gain under section 1374 in the year of the final inclusion date or an accelerated loss inclusion date.

To the extent that a trust from which stock is redeemed is wholly or partially a grantor trust, the proposed rules treat the redeemed stock as having been owned directly by the grantor. When stock is redeemed from an estate or from a trust that is not a wholly grantor trust, and all or a portion of a distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock that is not attributable to the basis of redeemed stock treated as owned by the grantor is not taken into account by such estate or trust until the final inclusion date or an accelerated loss inclusion date. In that case, whether a particular date is the final inclusion date or an accelerated loss inclusion date is determined by treating such estate or trust, not its beneficiaries, as the redeemed shareholder. In the event that the trust or estate terminates before it has been permitted to take into account all of the loss attributable to the basis of redeemed stock, any remaining loss is treated as a loss under section 172 or section 1212 for purposes of section 642(h) (regarding the availability to beneficiaries of unused loss carryovers and excess deductions of an estate or trust upon termination). Each beneficiary's interest in the loss distributed under section 642(h), however, shall be limited to the proportion of that loss that is equal to the proportion of the total amount of the distribution treated as a dividend that is represented by that beneficiary's beneficial interest in that dividend. Once all or a portion of such a loss is distributed to a ben-

eficiary, whether a particular date is the final inclusion date or an accelerated loss inclusion date with respect to such a loss is determined by treating such beneficiary as the redeemed shareholder.

3. Special rules related to apportionment of interest and other expenses

Under section 864(e), taxpayers apportion interest expense between U.S. and foreign source income on the basis of the relative values of their U.S. and foreign assets. For this purpose, taxpayers may choose to value their assets using either fair market value or tax book value (adjusted basis). If the taxpayer apportions interest expense using tax book value, the adjusted basis of stock in any nonaffiliated 10 percent owned corporation (as defined in section 864(e)(4)(B)) is increased by the amount of earnings and profits (and reduced by any deficits in earnings and profits) attributable to such stock that accumulated during the period the taxpayer held such stock. The proposed regulations provide that for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis in any remaining shares of the redeeming corporation that are owned by the redeemed shareholder or certain affiliated corporations will be increased by the amount of the unutilized basis of redeemed stock. This adjustment is intended to provide consistent interest allocation consequences in the case of dividends and redemptions treated as dividends by non-affiliated 10 percent owned corporations.

B. Revisions to Regulations Under Section 304

The current regulations under section 304 do not reflect all of the legislative amendments that have been made to section 304. This notice of proposed rulemaking proposes certain revisions to the current regulations under section 304 to incorporate these legislative amendments to the extent that those legislative amendments are relevant to the issues that are subject to the proposed regulations under section 302. In particular, these revisions reflect the amendments to section 304 made by section 1013 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 918) (August 5, 1997), that provide that, to the extent that a stock acquisition to which section

304(a)(1) applies is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is treated as having issued. The same rules that govern an actual redemption govern a deemed redemption.

In transactions under section 304 that involve one or more foreign corporations, further consequences may apply under the international provisions of the Code. For example, where target corporation stock is transferred to a foreign corporation in the deemed section 351 transaction, section 367 and the regulations promulgated thereunder apply to the transfer. See Rev. Rul. 91-5, 1991-1 C.B. 114, (holding that section 367 applied to the deemed contribution to capital of the target corporation stock under prior law because section 367(c)(2) resulted in the stock transfer constituting a section 351 transaction). The IRS intends to issue guidance on the application of the international provisions to section 304 transactions and requests comments on such transactions, including what changes, if any, to existing published guidance may be appropriate in light of the 1997 amendments to section 304.

Proposed Effective Date

These regulations are proposed to apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. It is hereby certified that the collection of information in this Notice of Proposed Rulemaking will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the IRS and Treasury estimate that at most 3,000 taxpayers will be subject to these requirements and most of those taxpayers will be individuals or large businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C.

chapter 6) is not required. Pursuant to section 7805(f), this notice of proposed rule-making will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 20, 2003, beginning at 10 a.m. in Room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by January 30, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Lisa K. Leong of the Office of the Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury participated in their development.

Proposed Amendments to the Regulations

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

PART 1— INCOME TAXES

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

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

§ 1.302–2 [Amended]

Par. 2. In § 1.302–2, paragraph (c) is removed.

Par. 3. Section 1.302–5 is added to read as follows:

§ 1.302–5 *Redemptions taxable as dividends.*

(a) *In general.* In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, an amount equal to the basis of the redeemed stock, after adjusting such basis to reflect the application of section 301(c)(2), 961(b), 1059, § 1.1502–32, or any other applicable provision of the Internal Revenue Code or the regulations thereunder, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. The redeemed shareholder (as defined in paragraph (b)(1) of this section) shall be permitted to take such loss into account pursuant to the provisions of this section. Although such loss may be taken into account on a date later than the date of the redemption, the attributes (*e.g.*, character and source) of such loss are determined on the date of the redemption of the stock that gave rise to such loss. See § 1.1502–19(b)(5) for rules that apply where an amount received in redemption of stock is treated as a dividend and such amount either increases or creates an excess loss account in the redeemed stock.

(b) *Definitions*—(1) *Redeemed shareholder.* Except as provided in paragraphs (d)(6), (7), and (8) of this section, the redeemed shareholder is the person whose stock is redeemed in a transaction in which a portion or all of the redemption proceeds are treated as a dividend. If the assets of the redeemed shareholder are acquired in a transaction described in sec-

tion 381(a), the acquiring corporation (within the meaning of section 381) thereafter is treated as the redeemed shareholder. For rules concerning the person that is treated as the redeemed shareholder where the redeemed stock is held by a partnership or an S corporation at the time of the redemption, see paragraphs (d)(6) and (7) of this section. For rules concerning the person that is treated as the redeemed shareholder where the redeemed stock is held by an estate or a trust not treated as wholly owned by the grantor or another person at the time of the redemption and a loss attributable to the basis of such redeemed stock is distributed to a beneficiary of such estate or trust, see paragraph (d)(8) of this section.

(2) *Redeeming corporation.* Except as provided in paragraph (d)(5) of this section, the redeeming corporation is the corporation that issued the stock that is redeemed. For rules concerning the entity that is treated as the redeeming corporation where the redeeming corporation ceases to exist in a transaction described in section 381(a) or where the redeeming corporation distributes to its shareholders stock of one or more controlled corporations in a distribution described in section 355(a), see paragraph (d)(5) of this section.

(3) *Final inclusion date.* Except as otherwise provided in paragraphs (d)(5), (6), (7), and (8) of this section, the final inclusion date is the first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2), or (3) if the facts and circumstances that exist at the end of such day had existed immediately after the redemption. In addition, a date is the final inclusion date if there is no later date on which the redeemed shareholder could take the loss into account. For purposes of the preceding sentence, the existence or creation of a limitation under section 382 is not treated as preventing the loss from being taken into account. For example, if the redeemed shareholder is an individual, the final inclusion date includes the date of death of such individual. If the redeemed shareholder is a corporation, the final inclusion date includes the date such corporation transfers its assets in a liquidation described in section 331. If the redeemed shareholder is a foreign corporation, the final inclusion date includes the date such corporation transfers its assets to a do-

mestic corporation in either a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies. If the redeemed shareholder is a foreign corporation that is not a controlled foreign corporation, within the meaning of section 957(a), on the date of the redemption, the term final inclusion date includes the date such corporation transfers its assets to a controlled foreign corporation in a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies.

(4) *Accelerated loss inclusion date.* An accelerated loss inclusion date is a date other than the final inclusion date on which the redeemed shareholder must take into account gain from an actual or deemed sale or exchange of stock of the redeeming corporation. For example, the redeemed shareholder must take into account gain from an actual or deemed sale or exchange of stock of the redeeming corporation when such shareholder receives a distribution with respect to stock of the redeeming corporation to which section 301(c)(3) applies, recognizes gain on stock of the redeeming corporation as a result of the application of section 475, recognizes gain on a sale or exchange of stock of the redeeming corporation (even if such gain is characterized as a dividend under section 1248), recognizes gain in connection with a constructive sale of stock of the redeeming corporation within the meaning of section 1259, or is a partner of a partnership or a shareholder of an S corporation that is allocated, and must take into account, gain recognized on the partnership's or S corporation's sale or exchange of stock of the redeeming corporation.

(c) *Inclusion of loss attributable to basis of redeemed stock*—(1) *Amount taken into account on final inclusion date.* On the final inclusion date, the redeemed shareholder is permitted to take into account the loss attributable to the basis of redeemed stock, reduced by the amount of such loss that was previously taken into account pursuant to paragraph (c)(2) of this section.

(2) *Amount taken into account on accelerated loss inclusion date.* On an accelerated loss inclusion date, the redeemed shareholder is permitted to take into account the loss attributable to the basis of redeemed stock in the amount of the lesser of—

(i) The amount of such loss reduced by the amount of such loss previously taken into account pursuant to this paragraph (c)(2); and

(ii) The amount of gain recognized with respect to stock of the redeeming corporation that must be taken into account by the redeemed shareholder on such accelerated loss inclusion date.

(d) *Special rules*—(1) *Treatment of loss attributable to basis of redeemed stock.* Except as otherwise provided in this section, for purposes of applying the provisions of the Internal Revenue Code and the regulations thereunder, any loss attributable to the basis of redeemed stock that has not been permitted to be taken into account shall be treated as a net operating loss carryforward or a capital loss carryforward, as applicable. For example, for purposes of determining under sections 382 and 383 whether the redeemed shareholder is a loss corporation that has an ownership change and whether the loss attributable to the basis of redeemed stock is a pre-change loss, any loss attributable to the basis of redeemed stock that the redeemed shareholder is not permitted to take into account before a testing date shall be treated as a net operating loss carryforward or a capital loss carryforward, as applicable, that arose in the taxable year in which the redemption that gave rise to such loss occurred and that can be carried forward to the taxable year that includes the testing date. If such loss is treated as a pre-change loss because of an ownership change on the testing date, it is subject to the section 382 limitation (and the other rules of section 382 or 383) for any post-change year in which it is taken into account under paragraph (c) of this section and any other post-change year to which it is carried pursuant to section 172 or 1212, as applicable, and paragraph (d)(2) of this section. The order in which the loss is absorbed (and in which it absorbs the section 382 limitation (see § 1.383-1(d)(2)), however, is determined in a manner consistent with the principles of section 172 or 1212, as applicable, and paragraph (d)(2) of this section.

(2) *Net operating loss deduction and capital loss carrybacks and carryovers.* For purposes of sections 172 and 1212, any portion of a loss attributable to the basis of redeemed stock shall be treated as occurring in the taxable year in which the redeemed shareholder is permitted to take such loss

into account, not the taxable year of the redemption that gave rise to such loss. If an estate or trust terminates before it is permitted to take into account all of the loss attributable to the basis of redeemed stock, such loss that it has not been permitted to take into account is treated as a loss under section 172 or 1212 for purposes of section 642(h), provided, however, that the identification of carryover years of the beneficiaries will be determined in accordance with the preceding sentence. Notwithstanding the preceding sentence, each beneficiary's interest in the loss distributed under section 642(h) shall be limited to the proportion of that loss that is equal to the proportion of the total amount of the distribution treated as a dividend that is represented by that beneficiary's beneficial interest in that dividend. If a deduction for any portion of such loss is disallowed by section 382 or 383 for the taxable year in which the redeemed shareholder is permitted to take such loss into account, such portion shall be carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of net operating losses or capital losses, as applicable, but shall be subject to the section 382 limitation (and the other rules of sections 382 and 383) for any post-change year to which it is carried.

(3) *Expenses apportioned on the basis of assets.* For special rules regarding adjustments in the case of taxpayers apportioning expenses on the basis of the tax book value of assets, see § 1.861-12(c)(2)(vi).

(4) *Effect of loss attributable to basis of redeemed stock on earnings and profits.* If the redeemed shareholder is a corporation, any loss attributable to the basis of redeemed stock is not reflected in such corporation's earnings and profits before it is taken into account pursuant to the rules of paragraph (c) of this section. See, for example, §§ 1.312-6(a), 1.312-7, and 1.1502-33(c)(2).

(5) *Successors to the redeeming corporation*—(i) *Acquisitive transactions.* If the assets of the redeeming corporation are acquired by another corporation in a transaction described in section 381(a), the determination of whether a particular date is the final inclusion date or an accelerated loss inclusion date is made by treating the facts and circumstances that exist at the end of such day (including the ac-

quisition of the assets of the redeeming corporation) as existing immediately after the redemption and treating the acquiring corporation (within the meaning of section 381) as the redeeming corporation.

(ii) *Divisive transactions.* In general, if the redeeming corporation distributes to its shareholders the stock of one or more controlled corporations in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the loss attributable to the basis of redeemed stock is allocated among the stock of the distributing and any controlled corporations that the redeemed shareholder owns, actually and constructively pursuant to the rules of section 318, immediately after the distribution in proportion to the fair market value of the stock of the distributing corporation that the redeemed shareholder is treated as so owning and the distributed stock of the controlled corporation that the redeemed shareholder is treated as so owning. To the extent that such loss is allocated to the stock of the distributing corporation, the distributing corporation will be treated as the redeeming corporation for purposes of determining whether a particular date is the final inclusion date or an accelerated loss inclusion date with respect to such loss. To the extent that such loss is allocated to the stock of a controlled corporation, such controlled corporation will be treated as the redeeming corporation for purposes of determining whether a particular date is the final inclusion date or an accelerated loss inclusion date with respect to such loss. Where the controlled corporation was wholly owned by the distributing corporation and all of the stock of the controlled corporation was distributed to the shareholders of the distributing corporation in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the determination of whether a particular date is the final inclusion date with respect to a loss that is allocated to a controlled corporation is made by treating the redeemed shareholder as owning a percentage of stock of the controlled corporation immediately prior to the redemption equal to the percentage of stock of the distributing corporation the redeemed shareholder actually and constructively owned immediately prior to the redemption. In all other cases, appropriate calculations shall apply to determine whether a particular date is the final inclusion date.

(6) *Redeemed shareholder is a partnership*—(i) *Treatment and allocation of loss attributable to basis of redeemed stock.* Where stock is redeemed from a partnership and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock is treated as a current loss to the partnership on the date of the redemption. To the extent of the lesser of the amount of such distribution that is treated as a dividend and such loss that is not allocated pursuant to section 704(c) and the regulations thereunder, the dividend and the loss must be allocated in equal amounts. Such amounts must be allocated in accordance with the partners' interests in the partnership. An allocation will be deemed to be in accordance with a partner's interest in the partnership if the allocation is in the same proportion as the allocation of the excess of the dividend income over the loss attributable to the basis of the redeemed stock, if any, the excess of the loss attributable to the basis of the redeemed stock over the dividend income, if any, or, if neither, in the same proportion as the partnership's net taxable income or loss for the year is allocated. The excess dividend or loss attributable to the basis of redeemed stock must be allocated to the partners in a manner that takes into account the requirements of section 704. The loss attributable to the basis of redeemed stock allocated to a partner under the rules of this section is not taken into account until the final inclusion date or an accelerated loss inclusion date, as provided in this section.

(ii) *Identification of redeemed shareholder.* For purposes of determining whether a particular date is the final inclusion date with respect to a loss that is allocated to a partner, if the partner is a partner of the partnership at the end of such day, the partnership is treated as the redeemed shareholder. If the partner is not a partner of the partnership at the end of such day, the former partner is treated as the redeemed shareholder and the determination of whether such date is the final inclusion date is made by comparing such former partner's actual and constructive ownership of the redeeming corporation immediately prior to the redemption to such former partner's actual and constructive ownership of the redeeming corporation at the end of such particular day. For purposes of deter-

mining whether a particular date is an accelerated loss inclusion date with respect to a loss attributable to the basis of redeemed stock that is allocated to a partner from a partnership, the partner is treated as the redeemed shareholder.

(7) *Redeemed shareholder is an S corporation*—(i) *Treatment and allocation of loss attributable to basis of redeemed stock.* Where stock is redeemed from an S corporation and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock is treated as a current loss to the S corporation on the date of the redemption and is allocated to the S corporation's shareholders under section 1366(a). The portion of such loss that is allocated to an S corporation shareholder from the S corporation is not permitted to be taken into account by such shareholder until the final inclusion date or an accelerated loss inclusion date, as provided in this section.

(ii) *Identification of redeemed shareholder.* For purposes of determining whether a particular date is the final inclusion date with respect to a loss attributable to the basis of redeemed stock that is allocated to a shareholder of an S corporation from an S corporation, if the S corporation shareholder is a shareholder of the S corporation at the end of such day, the S corporation is treated as the redeemed shareholder. If the S corporation shareholder is not a shareholder of the S corporation at the end of such day, the former S corporation shareholder is treated as the redeemed shareholder and the determination of whether such date is the final inclusion date is made by comparing such former S corporation shareholder's actual and constructive ownership of the redeeming corporation immediately prior to the redemption to such former S corporation shareholder's actual and constructive ownership of the redeeming corporation at the end of such particular day; provided, however, that for purposes of computing such former S corporation shareholder's ownership of the redeeming corporation immediately prior to the redemption, section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein. For purposes of determining whether a particular date is an accelerated loss inclusion date with respect to a loss attributable to the basis of redeemed stock that is allocated to an S cor-

poration shareholder from an S corporation, the S corporation shareholder is treated as the redeemed shareholder.

(8) *Redeemed shareholder is an estate or trust.* To the extent that a trust from which stock is redeemed is treated as owned (in part or in whole) by the grantor or another person under subpart E of part I of subchapter J of the Internal Revenue Code, the rules of this section are applied as though the redeemed stock were owned directly by such grantor or other person. Where stock is redeemed from an estate or from a trust not treated as wholly owned by the grantor or another person under subpart E of part I of subchapter J of the Internal Revenue Code, and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock, except any loss attributable to the basis of redeemed stock treated as owned by the grantor or another person, is not taken into account by such estate or trust until the final inclusion date or an accelerated loss inclusion date, and whether a particular date is the final inclusion date or an accelerated loss inclusion date is determined by treating such estate or trust, not its beneficiaries, as the redeemed shareholder. However, if all or a portion of such loss is distributed to a beneficiary of such estate or trust pursuant to section 642(h) and paragraph (d)(2) of this section, the determination of whether a particular date is the final inclusion date or an accelerated inclusion date shall be made by treating each such beneficiary as the redeemed shareholder with respect to the loss distributed to such beneficiary.

(9) *Redeemed shareholder is a C corporation that converts to an S corporation.* For rules regarding the treatment of a loss attributable to the basis of redeemed stock when the redeemed shareholder is a C corporation on the date of the redemption and elects to be taxed as an S corporation prior to the final inclusion date or an accelerated loss inclusion date, see §§ 1.1371-1(a)(1) and 1.1374-5(b)(2).

(e) *Statement to be filed with returns.* With or as part of the income tax return for the year in which a redeemed shareholder takes into account any loss pursuant to this section, the redeemed shareholder shall provide a statement entitled "Claim of Loss Attributable to Basis of Redeemed Stock." The statement shall specify the amount of the

loss that is taken into account on such return pursuant to this section and shall identify the shares to which such amounts relate.

(f) *Examples.* For purposes of the examples in this section, each of corporation X, corporation Y, corporation Z, corporation D, and corporation C is a domestic corporation that files U.S. tax returns on a calendar-year basis. The principles of this section are illustrated by the following examples:

Example 1. (i) *Facts.* A and B, husband and wife, each own 100 shares (50 percent) of the stock of corporation X and hold the corporation X stock as a capital asset. A purchased his corporation X shares on February 1, Year 1, for \$200. On December 31, Year 1, corporation X redeems all of A's 100 shares of its stock for \$300. At the end of Year 1, corporation X has current and accumulated earnings and profits of \$200. In connection with the redemption transaction, A does not file an agreement described in section 302(c)(2) waiving the application of the family attribution rules. The redemption proceeds, therefore, are treated under section 301(c)(1) as a dividend to the extent of corporation X's earnings and profits of \$200, and under section 301(c)(2) as a recovery of basis in the amount of \$100. On July 1, Year 2, B sells all of her shares of corporation X stock to G, her mother.

(ii) *Analysis.* Under this section, an amount equal to A's basis in the corporation X stock (\$100 after application of section 301(c)(2)) is treated as a loss recognized on a disposition of the redeemed stock on December 31, Year 1, the date of the redemption. When B sells her shares to G, A no longer owns, actually or constructively, any shares of corporation X stock. Thus, if the facts that existed at the end of July 1, Year 2, had existed immediately after the redemption, A would have been treated as having received a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Under this section, therefore, July 1, Year 2, is the final inclusion date and, on that date, A is permitted to take into account the loss of \$100 attributable to his basis in the redeemed stock. Because that loss is treated as having been recognized on a disposition of the redeemed stock on the date of the redemption, December 31 of Year 1, such loss is treated as a short-term capital loss.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that, instead of selling all of her 100 shares of corporation X stock to G on July 1, Year 2, B sells only 75 shares of corporation X stock to G on that date.

(ii) *Analysis.* As in *Example 1*, an amount equal to A's basis in the redeemed stock (\$100 after application of section 301(c)(2)) is treated as a loss recognized on a disposition of the redeemed stock on December 31, Year 1, the date of the redemption. Immediately after B's sale of 75 shares of corporation X stock to G, A constructively owns 25 percent of the shares of corporation X stock. Thus, if the facts that existed at the end of July 1, Year 2, had existed immediately after the redemption, A would have been treated as receiving a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Under this section, therefore, July 1, Year 2, is the final inclusion date and, on that date,

A is permitted to take into account the loss of \$100 attributable to his basis in the redeemed stock. Because that loss is treated as having been recognized on a disposition of the redeemed stock on the redemption date, December 31 of Year 1, such loss is treated as a short-term capital loss.

Example 3. (i) *Facts.* Corporation Y has 200 shares of common stock outstanding. L, an individual, owns 150 shares of common stock in corporation Y and has owned these shares for several years. The remaining 50 shares are owned by K, L's father. In Year 1, corporation Y redeems 50 shares of L's corporation Y stock, which have a basis of \$75, for \$200. At the end of Year 1, corporation Y's current and accumulated earnings and profits exceed \$200. The redemption of L's stock is treated as a distribution to which section 301 applies. L recognizes dividend income in the amount of \$200. In Year 4, L sells 25 of his remaining shares of corporation Y stock, which have a basis of \$50, to K for \$100 and recognizes \$50 of long-term capital gain.

(ii) *Analysis.* Under this section, an amount equal to L's basis in the corporation Y stock that is redeemed, \$75, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. The date on which L sells 25 shares of corporation Y stock to K is not the final inclusion date under paragraph (b)(3) of this section because L does not satisfy the criteria of section 302(b)(1), (2), or (3) at the end of such day. Under paragraph (b)(4) of this section, however, that date is an accelerated loss inclusion date because, on that date, L recognizes gain of \$50 on a disposition of stock of corporation Y, the redeeming corporation. Thus, on that date, L is permitted to take into account \$50 of the loss attributable to his basis in the redeemed stock. The remaining \$25 of such loss is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized).

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that L does not sell any shares of corporation Y to K in Year 4. Instead, in Year 4, corporation Y distributes \$75 to L with respect to his remaining 100 shares of corporation Y stock. L's basis in these shares is only \$30, and at the end of Year 4, corporation Y's current and accumulated earnings and profits are \$20, instead of \$200. Under section 301(c)(1), \$20 of the distribution is treated as a dividend, under section 301(c)(2), \$30 of the distribution is treated as a recovery of basis, and, under section 301(c)(3), \$25 of the distribution is treated as gain from the sale or exchange of stock.

(ii) *Analysis.* As in *Example 3*, an amount equal to L's basis in the corporation Y stock redeemed in Year 1, \$75, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Because L recognizes gain under section 301(c)(3) upon the receipt of the Year 4 distribution, the date of that distribution is an accelerated loss inclusion date. Accordingly, on that date, L is permitted to take into account \$25 of the loss attributable to the basis of the redeemed stock. The remaining \$50 of such loss is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized).

Example 5. (i) *Facts.* Corporation Z has 100 shares of stock outstanding, 50 shares of which are owned by each of A and his son, B. A's basis in each of his shares of corporation Z stock is \$1. During Year 1, corporation Z redeems from A 25 shares of corpora-

tion Z stock for \$200. At the end of Year 1, corporation Z has current and accumulated earnings and profits in excess of \$200. The redemption is treated as a distribution to which section 301 applies. Accordingly, A recognizes dividend income of \$200. In Year 2, corporation Y acquires all of corporation Z's assets in exchange solely for voting stock in a reorganization described in section 368(a)(1)(C). In the reorganization, A and B surrender their shares of corporation Z stock. A receives 2,500 shares of common stock of corporation Y and B receives 5,000 shares of common stock of corporation Y. Immediately after the reorganization, corporation Y has outstanding one million shares of common stock.

(ii) *Analysis.* Under this section, an amount equal to A's basis in the redeemed stock after the Year 1 redemption, \$25, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Under paragraph (d)(5) of this section, for purposes of determining whether a particular date on or after the date of the reorganization is the final inclusion date or an accelerated loss inclusion date, corporation Y, the acquiring corporation, is treated as the redeeming corporation. If the facts and circumstances that exist at the end of the day of the reorganization had existed on the date of the redemption, the redemption would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, the date of the reorganization is the final inclusion date and A is permitted to take into account the loss of \$25 attributable to his basis in the redeemed stock.

Example 6. (i) Facts. Corporation D has 300 shares of stock outstanding. J and her two daughters, M and N, each own 100 shares of corporation D stock. J's basis in her corporation D shares is \$400. In Year 1, corporation D redeems all of J's shares for \$1,000. At the end of Year 1, corporation D has current earnings and profits exceeding \$1,000. The redemption is treated as a distribution to which section 301 applies. Accordingly, J recognizes dividend income in the amount of \$1,000. Subsequently, M and N decide to separate corporation D's business. Accordingly, they cause corporation D to contribute one-half of its assets to corporation C, a newly formed corporation, in exchange for all of corporation C's stock and to distribute all of the corporation C stock to N in exchange for all of her corporation D stock. Immediately after the distribution, the value of corporation D is equal to the value of corporation C. In Year 6, M sells her shares in corporation D to an unrelated person.

(ii) *Analysis.* Under this section, an amount equal to J's basis in the corporation D stock redeemed, \$400, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Upon corporation D's distribution of the stock of corporation C in Year 2, J's loss attributable to the basis of the redeemed corporation D stock is allocated among the stock of corporation D and corporation C that J owns, actually and constructively, immediately after the distribution in proportion to the fair market value of the stock of each such corporation. Although J does not actually own any stock of corporation D or corporation C, because J constructively owns all of the stock of both corporation D and corporation C and each of the stock of corporation D and the stock of corporation C have the same value immediately after the distribution, \$200 of the loss is allocated to each of the stock of corporation D and the stock of cor-

poration C that J is treated as so owning. Accordingly, each of corporation D and corporation C is treated as the redeeming corporation for purposes of determining whether a particular date after the date of the distribution is an accelerated loss inclusion date or the final inclusion date with respect to \$200 of the loss. In this case, the date in Year 6 on which M sells her corporation D stock to an unrelated person is the final inclusion date with respect to J's loss allocated to J's constructively owned corporation D stock, because had corporation D's distribution of corporation C stock occurred immediately after the redemption of J's stock and M's Year 6 sale of corporation D stock occurred immediately thereafter in Year 1, the redemption of J's corporation D stock would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Accordingly, on that date in Year 6, J is permitted to take into account the \$200 loss allocated to the corporation D stock. The \$200 loss allocated to the corporation C stock is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized) with respect to the corporation C stock.

Example 7. (i) Facts. In Year 1, A and B, two unrelated individuals, each contribute \$100 to form a 50-50 general partnership, PS. A and B share in the income of PS equally. PS buys 100 shares of corporation Z stock for \$200. A owns the remaining 400 outstanding shares of corporation Z stock directly. In Year 2, corporation Z redeems all of PS's shares for \$300. At that time, the basis of A's interest in PS is \$100 and the basis of B's interest in PS is \$100. At the end of Year 2, corporation Z has current and accumulated earnings and profits of \$150. Because A's ownership of the Z stock is attributed to PS under section 318(a)(3)(A), the redemption is treated as a distribution to which section 301 applies. The redemption proceeds, therefore, are treated as a dividend to the extent of corporation Z's earnings and profits, \$150, and as a recovery of basis in the amount of \$150. Assume that PS's only items of income, gain, loss, deduction, and credit for Year 2 arise from the redemption of the corporation Z stock. On January 1 of Year 4, A sells his entire interest in PS to C, an unrelated individual.

(ii) *Analysis.* Under this section, an amount equal to PS's basis in the corporation Z stock, (\$50 after application of section 301(c)(2)), is treated as a current loss recognized by the partnership on a disposition of the redeemed stock on the date of the redemption. Under this section, \$50 of the dividend and \$50 of the loss must be allocated in equal amounts in accordance with A's and B's interests in PS. Accordingly, if the remaining \$100 of the dividend is allocated \$50 to A and \$50 to B under section 704 and the regulations thereunder, \$25 of each of the dividend and the loss is allocated to each of A and B. A's and B's basis in their PS interests are increased by their shares of the dividend and decreased by their shares of the loss attributable to the basis of the redeemed stock. A and B will not be able to take that loss into account until the final inclusion date or an accelerated loss inclusion date. When A sells his PS interest to C, an unrelated individual, PS and A are no longer related. Therefore, PS no longer owns, actually or constructively, any shares of corporation Z stock. Because B remains a partner in PS after January 1, Year 4, PS is treated as the redeemed shareholder for purposes of determining if January 1, Year 4, is the final in-

clusion date for B. If the facts that exist at the end of the day of A's sale of his PS interest to C had existed immediately after the redemption, PS would have been treated as receiving a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, B is permitted to take into account the \$25 loss attributable to the basis of the redeemed stock that was allocated to him. Because A is no longer a partner in PS after January 1, Year 4, A is treated as the redeemed shareholder for purposes of determining if January 1, Year 4, is the final inclusion date for A. Immediately prior to the redemption, A actually and constructively owns 90 percent of the corporation Z stock. After the sale of the PS interest, A actually owns 100 percent of the corporation Z stock. If these facts had existed immediately after the redemption, A would not have been treated as receiving a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, January 1, Year 4, is not the final inclusion date for A.

Example 8. (i) Facts. H, I, and J are shareholders in corporation S, a corporation that has made a valid election to be taxed as an S corporation. H, I, and J respectively hold 60 percent, 20 percent, and 20 percent of the stock in corporation S. H, I, and J have no relation to each other apart from their ownership interests in corporation S. Corporation S owns 20 percent of the outstanding shares of corporation X with a \$100 adjusted basis. H owns the remaining outstanding shares of corporation X. In Year 1, all of corporation S's shares of corporation X stock are redeemed for their fair market value, \$200. Corporation X has current and accumulated earnings and profits of \$300 at the end of Year 1. Because H's ownership of X stock is attributed to corporation S under section 318(a)(2)(C), the redemption is treated as a distribution to which section 301 applies and is treated as a dividend. H, I, and J will be allocated \$120, \$40, and \$40 of dividend income, respectively. In Year 2, J sells his stock of corporation S to K, an unrelated person. In Year 3, H sells his stock of corporation X to L, an unrelated person.

(ii) *Analysis.* Under this section, an amount equal to corporation S's basis in the redeemed stock (\$100) is treated as a loss recognized on a disposition of the redeemed stock on the date of the disposition. H, I, and J will be allocated \$60, \$20, and \$20 of the loss, respectively, in the year of the redemption. Both the allocation of dividend income and the allocation of the loss give rise to adjustments to each shareholder's basis in corporation S. H, I, and J, however, will not be able to take into account this loss until the final inclusion date or an accelerated loss inclusion date. In Year 2, when J sells his stock of corporation S to K, J is no longer a shareholder in corporation S and will be treated as the redeemed shareholder for purposes of determining whether a particular date is the final inclusion date or an accelerated loss inclusion date. In addition, the determination of whether the date of the Year 2 sale is the final inclusion date for J is made by comparing J's actual and constructive ownership of corporation S stock immediately prior to the redemption to J's actual and constructive ownership of corporation S stock at the end of the date of the Year 2 sale. However, for purposes of computing J's ownership of the redeeming corporation immediately prior to the redemption, section 318(a)(2)(C) is applied without regard to the 50 percent limitation contained therein. Immediately prior to the redemption,

therefore, J is treated as owning actually and constructively 4 percent of the stock of corporation X and, at the end of the day of J's sale of corporation S stock, J owns, actually and constructively, no corporation X stock. Therefore, if the facts that existed on the date of the Year 2 sale had existed immediately after the redemption, J would have been treated as having received a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, the date of J's sale of corporation S stock to K is the final inclusion date. J is permitted to take into account J's share of the loss attributable to the basis of the redeemed stock as of that date. While H and I remain shareholders of corporation S, whether a particular date is the final inclusion date will be determined by treating corporation S as the redeemed shareholder. Thus, in Year 3 when H disposes of his shares of corporation X, corporation S actually and constructively owns no stock of corporation X. As of that date, therefore, H and I will be permitted to take into account their respective shares of the loss attributable to the basis of the redeemed stock.

(g) *Effective date.* This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.304-1 is revised to read as follows:

§ 1.304-1 *In general.*

(a) *In general.* Section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Sales to which section 304 is applicable shall be treated as redemptions subject to sections 302 and 303.

(b) *Effective date.* This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 1.304-2 is amended as follows:

1. Paragraphs (a) and (c) are revised.
2. Paragraph (d) is added.

The revisions and addition read as follows:

§ 1.304-2 *Acquisition by related corporation (other than subsidiary).*

(a) *In general.* (1) If a corporation (the acquiring corporation), in return for property, acquires stock of another corporation (the issuing corporation) from one or more persons, and the person or persons from whom the stock was acquired were in control of both such corporations, then such property shall be treated as received in redemption of stock of the acquiring corporation. As to each person transferring stock, the amount received shall be treated as a

distribution to which section 301 applies if section 302(a) or 303 does not apply. For rules regarding the amount constituting a dividend in such cases, see § 1.304-6.

(2) In applying section 302(b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to its ownership of stock in the acquiring corporation (except for purposes of applying section 318(a)), section 318(a) (relating to the constructive ownership of stock) shall be applied without regard to the 50 percent limitation contained in section 318(a)(2)(C) and (3)(C), and a series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations.

(3) If, pursuant to section 302(d), section 301 applies to the property treated as received in redemption of stock of the acquiring corporation pursuant to paragraph (a)(1) of this section, the transferor and the acquiring corporation shall be treated, for all Federal income tax purposes, in the same manner as if the transferor had transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in the transaction in exchange for the property. Accordingly, under section 362, the acquiring corporation's basis in the stock of the issuing corporation is equal to the basis the transferor had in that stock and, under section 358, the transferor's basis in the stock of the acquiring corporation deemed issued to the transferor in the deemed transaction to which section 351(a) applies is equal to the transferor's basis in the stock of the issuing corporation it surrendered. Section 1.302-5 applies to the transferor's unutilized basis, if any, in the stock of the acquiring corporation treated as redeemed in connection with an acquisition described in paragraph (a)(1) of this section by treating the acquiring corporation as the redeeming corporation and the transferor as the redeemed shareholder.

(4) If section 301 does not apply to the property treated as received in redemption of stock of the acquiring corporation pursuant to paragraph (a)(1) of this section, the property received by the transferor shall be treated as received in a

distribution in full payment in exchange for stock of the acquiring corporation under section 302(a). The basis and holding period of the stock of the acquiring corporation that is treated as having been redeemed shall be the same as the basis and holding period of the stock of the issuing corporation actually surrendered. The acquiring corporation shall take a cost basis in the stock of the issuing corporation that it acquires. See section 1012.

* * * * *

(c) *Examples.* For purposes of the examples in this section, each of corporation X and corporation Y is a domestic corporation that files U.S. tax returns on a calendar-year basis. The principles of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Corporation X and corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half of the stock of each corporation, B owns one-half of the stock of corporation X, and C owns one-half of the stock of corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of corporation X, which have an adjusted basis of \$10,000, to corporation Y for \$50,000.

(ii) *Analysis.* Because before the sale A owns 50 percent of the stock of corporation X and after the sale A owns only 35 percent of such stock (20 shares directly and 15 constructively because one-half of the 30 shares owned by corporation Y are attributed to A), the redemption is substantially disproportionate as to A pursuant to the provisions of section 302(b)(2). A, therefore, realizes a gain of \$40,000 (\$50,000 minus \$10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of corporation Y is not changed as a result of the sale. Under section 1012, the basis that corporation Y takes in the acquired stock of corporation X is its cost of \$50,000.

Example 2. (i) *Facts.* Corporation X and corporation Y each have outstanding 200 shares of common stock, all of which are owned by H, an individual. H has a basis in his corporation X stock of \$60 and in his corporation Y stock of \$30. Corporation X has \$80 of current and accumulated earnings and profits and corporation Y has \$80 of current and accumulated earnings and profits. H sells his 200 shares of corporation X stock to corporation Y for \$150.

(ii) *Analysis.* Because H is in control of both corporation X and corporation Y and receives property from corporation Y in exchange for the corporation X stock, H's sale of 200 shares of corporation X stock to corporation Y is subject to section 304(a)(1). Accordingly, H is treated as receiving \$150 as a distribution in redemption of corporation Y stock. Because H actually owns 100 percent of corporation X before the sale and is treated as owning 100 percent of corporation X after the sale, pursuant to section 302(d), section 302(a) does not apply to the deemed redemption distribution and the proceeds of the deemed redemption are treated as a distribution to which section 301 applies. Therefore, H is treated as transferring the corporation X stock to corporation Y in exchange for

corporation Y stock in a transaction to which section 351(a) applies. Corporation Y's basis in the corporation X stock acquired is \$60, the same basis that H had in the corporation X stock surrendered. H takes a basis of \$60 in the corporation Y stock he is treated as receiving in the deemed section 351 exchange. That corporation Y stock is then treated as redeemed by corporation Y for \$150. Under section 302, that redemption is treated as a distribution to which section 301 applies because H owns directly 100 percent of corporation Y both before and after the redemption of the corporation Y stock that was deemed issued. Thus, the deemed redemption proceeds are treated as a distribution to which section 301 applies. Pursuant to § 1.304-6(a), H is treated as receiving a dividend of \$150 (\$80 from the current and accumulated earnings and profits of corporation Y and then \$70 from the current and accumulated earnings and profits of corporation X). An amount equal to the basis in the corporation Y stock that H is deemed to receive and that is deemed redeemed, \$60 is treated as a loss recognized on a disposition of the stock deemed redeemed on the date of the deemed redemption and is taken into account under rules set forth in § 1.302-5. H's basis in the 200 shares of corporation Y stock that H owned before the sale and continues to own immediately after the sale remains \$30.

Example 3. (i) *Facts.* The facts are the same as in *Example 2*, except that corporation X has \$5 of current and accumulated earnings and profits and corporation Y has \$25 of current and accumulated earnings and profits.

(ii) *Analysis.* As in *Example 2*, H takes a basis of \$60 in the corporation Y stock he is treated as receiving and \$150 is treated as a distribution to which section 301 applies. Pursuant to § 1.304-6(a), H is treated as receiving a dividend of \$30 (\$25 from the current and accumulated earnings and profits of corporation Y and \$5 from the current and accumulated earnings and profits of corporation X). In addition, \$60 of the distribution is treated as a return of basis and \$60 of the distribution is treated as gain from the sale or exchange of corporation Y stock. H's basis in the 200 shares of corporation Y stock that he owned before and continues to own immediately after the sale remains \$30. Corporation Y's basis in the corporation X stock acquired is \$60, the same basis that H had in the corporation X stock surrendered.

Example 4. (i) *Facts.* A, an individual, owns 100 shares of corporation X stock, which is all of the outstanding stock of corporation X. A has a basis of \$1 in each share of his corporation X stock. B, the son of A, owns all the outstanding stock of corporation Y. A sells 25 shares of the stock of corporation X to corporation Y for \$50. For that year, the current and accumulated earnings and profits of corporation Y exceed \$50.

(ii) *Analysis.* Because A is in control of both corporation X and corporation Y (corporation X directly and corporation Y through attribution from B) and receives property in exchange for the corporation X stock, A's sale of corporation X stock to corporation Y is subject to section 304(a)(1). Consequently, A is treated as transferring the corporation X stock to corporation Y in exchange for corporation Y stock in a transaction to which section 351(a) applies. That corporation Y stock is then treated as redeemed by corporation Y for \$50. Before the deemed redemption of the corporation Y stock, A

owned 100 percent of corporation Y directly and constructively. After the deemed redemption, A owns 100 percent of corporation Y constructively by attribution from B. Accordingly, the redemption distribution is treated as a distribution to which section 301 applies. Because the earnings and profits of corporation Y exceed the amount of cash paid by corporation Y to A for the corporation X stock, pursuant to § 1.304-6(a), the entire amount is a dividend. An amount equal to the basis in the corporation Y stock that A was deemed to receive and that was then deemed redeemed, \$25, is treated as a loss recognized on a disposition of the stock deemed redeemed on the date of the deemed redemption and is taken into account under rules set forth in § 1.302-5. A's basis in the 75 shares that he continues to hold remains \$1 per share for an aggregate basis of \$75.

(d) *Effective date.* This section, except for paragraph (b) of this section, applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. Paragraph (b) of this section applies on and after December 2, 1955.

Par. 6. Section 1.304-3 is amended as follows:

1. Paragraph (a) is revised.
2. Paragraph (c) is added.

The revision and addition read as follows:

§ 1.304-3 Acquisition by a subsidiary.

(a) *In general.* If a subsidiary, in return for property, acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as if the parent corporation had redeemed its own stock in exchange for the property. For purposes of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination of whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. For rules regarding the amount that constitutes a dividend in a redemption treated as a distribution subject to section 301, see § 1.304-6. For the treatment of the redeemed shareholder's basis in the redeemed stock in such cases, see § 1.302-5. Section 1.302-5 applies to the shareholder's unutilized basis, if any, in the stock of the parent corporation treated as redeemed in connection with an acquisition described in this paragraph (a) by treating the par-

ent corporation as the redeeming corporation and the shareholder as the redeemed shareholder.

* * * * *

(c) *Effective date.* This section applies on and after December 2, 1955, except for paragraph (a) of this section, which applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 7. Section 1.304-5 is amended as follows:

1. Paragraph (a) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (c) is revised.

The revision and addition read as follows:

§ 1.304-5 Control.

(a) * * * Specifically, section 318(a) shall be applied by using the language "5 percent" instead of "50 percent" in section 318(a)(2)(C) and by using the language "5 percent" instead of "50 percent" in section 318(a)(3)(C), except that if section 318(a)(3)(C) would not have applied but for this substitution, by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation.

* * * * *

(c) *Effective date.* This section applies on and after January 20, 1994, except the last sentence of paragraph (a) of this section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 8. Section 1.304-6 is added to read as follows:

§ 1.304-6 Amount constituting a dividend.

(a) *In general.* The determination of the amount of the property that is a dividend is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. Where, however, the acquiring corporation is a foreign corporation, for purposes of the preceding sentence, the earnings and profits of the

acquiring corporation are taken into account only to the extent that they—

(1) Are attributable to stock of the acquiring corporation owned (within the meaning of section 958(a)) by a corporation or individual that is—

(i) A United States shareholder (within the meaning of section 951(b)) of the acquiring corporation; and

(ii) The transferor or a person who bears a relationship to the transferor described in section 267(b) or 707(b); and

(2) Were accumulated during the period or periods such stock was owned by such person while the acquiring corporation was a controlled foreign corporation.

(b) *Effective date.* This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 9. Section 1.704–1 is amended by adding paragraph (b)(4)(viii) to read as follows:

§ 1.704–1 *Partner’s distributive share.*

* * * * *

(b) * * *

(4) * * *

(viii) *Loss attributable to basis of redeemed stock under § 1.302–5.* For rules regarding allocations on a redemption of stock all or a portion of which is treated as a dividend, see § 1.302–5(d)(6)(i).

* * * * *

Par. 10. Section 1.861–12 is added to read as follows:

§ 1.861–12 *Characterization rules and adjustments for certain assets.*

(a) through (c)(2)(v) [Reserved]. For further guidance, see § 1.861–12T(a) through (c)(2)(v).

(c)(2)(vi) *Adjustments in respect of redeemed stock for taxpayers using the tax book value method.* Solely for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any stock in a 10 percent owned corporation owned directly by a taxpayer that is a redeemed shareholder (as defined in § 1.302–5(b)(1)) with respect to such corporation shall be increased by the amount of any loss that has not been taken into account under § 1.302–5(c) as of the close of the redeemed shareholder’s taxable year (unrecovered loss). If the redeemed share-

holder does not own directly any shares in the 10 percent owned corporation as of the end of the taxable year, but is treated for purposes of section 302(b) as owning shares actually owned by another member of the redeemed shareholder’s affiliated group, as defined in section 1504(a), or by a corporation that is either an affiliate described in § 1.904(i)–1(b)(1) or an affiliated corporation described in § 1.861–11T(d)(6) with respect to the redeemed shareholder, then the adjusted basis of the shares in the 10 percent owned corporation, if any, that are owned by such other corporation or corporations shall be increased by the amount of the redeemed shareholder’s unrecovered loss (and allocated among such corporations, if applicable, in proportion to their relative adjusted bases (as adjusted pursuant to this paragraph and § 1.861–12T(c)(2)) in the stock of the redeeming corporation). These adjustments are to be made annually and are noncumulative.

(vii) *Examples.* [Reserved]. Certain of the rules of this paragraph (c)(2) may be illustrated by the following examples:

Examples 1 and 2. [Reserved]. For further guidance, see § 1.861–12T(c)(2)(vii), *Examples 1 and 2.*

Example 3. The facts are the same as in § 1.861–12T(c)(2)(vii) *Example 2*, except that the taxable year is 2003, and during the taxable year Y redeems some of the shares of its stock held by X for \$100,000. X’s adjusted basis in the redeemed shares is \$50,000. Because X still owns all of the outstanding stock of Y, the redemption is treated as a distribution with respect to the stock of Y under section 301. Under § 1.302–5, X’s \$50,000 adjusted basis in the redeemed shares is treated as a loss recognized on the date of the redemption, none of which is taken into account in 2003. X invests the \$100,000 of redemption proceeds in assets that generate foreign source general limitation income. Under paragraph (c)(2)(vi) of this section, X’s adjusted basis in its remaining Y stock is considered to be \$2,000,000 (\$1,950,000 adjusted basis in the Y stock plus \$50,000 unrecovered loss in the redeemed shares). X’s adjusted basis of assets that generate foreign source general limitation income is considered to be \$2,500,000 (\$2,000,000 adjusted basis in the Y stock plus \$500,000 other assets), and the resulting apportionment of interest expense is the same as in § 1.861–12T(c)(2)(vii) *Example 2*.

(c)(3) through (j) [Reserved]. For further guidance, see § 1.861–12T(c)(3) through (j).

Par. 11. Section 1.861–12T is amended as follows:

1. Paragraph (c)(2)(vi) is redesignated as paragraph (c)(2)(vii).

2. New paragraph (c)(2)(vi) is added.

The addition reads as follows:

§ 1.861–12T *Characterization rules and adjustments for certain assets (temporary regulations.)*

* * * * *

(c) * * *

(2) * * *

(vi) [Reserved]. For further guidance, see § 1.861–12(c)(2)(vi).

* * * * *

Par. 12. Section 1.1371–1 is added to read as follows:

§ 1.1371–1 *Coordination with subchapter C.*

(a) *No carryover between C and S years—(1) Loss attributable to basis of redeemed stock.* A loss described in § 1.302–5(a) is treated as a carryforward arising in a taxable year for which a corporation is a C corporation. Therefore, it may not be carried to a taxable year for which such corporation is an S corporation.

(2)[Reserved].

(b) *Effective date.* This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 13. In § 1.1374–5, paragraph (a) is amended by adding a sentence at the end of the paragraph.

§ 1.1374–5 *Loss carryforwards.*

(a) *In general.* * * * However, for redemptions of stock occurring after the date these regulations are published as final regulations in the **Federal Register**, a loss attributable to the basis of redeemed stock that is taken into account pursuant to the rules of § 1.302–5 is allowed for purposes of section 1374(b)(2) as a deduction against net recognized built-in gain of the S corporation for the taxable year, provided that the loss arose in a year in which the corporation was a C corporation.

* * * * *

Par. 14. In § 1.1374–10, paragraph (a) is revised to read as follows:

§ 1.1374–10 *Effective date and additional rules.*

(a) *In general.* Except as provided in § 1.1374–5(a), §§ 1.1374–1 through

1.1374-9 apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

* * * * *

Par. 15. In § 1.1502-13, paragraph (f)(7) Example 3(b) is revised to read as follows:

§ 1.1502-13 Intercompany transactions.

* * * * *

(f) * * *

(7) * * *

Example 3. * * *

(b) *Treatment as a section 301 distribution.* The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of \$500 and, under section 358, a basis of \$250. Immediately after the merger, \$150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the \$150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, \$100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under § 1.1502-32. Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income is not included in gross income. Accordingly, P has a \$75 excess loss account in the redeemed stock. That excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption and is taken into account under the rules of § 1.1502-19(b)(5).

* * * * *

Par. 16. Section 1.1502-19 is amended as follows:

1. Paragraph (b)(2)(i) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (b)(5) is added.

3. Paragraph (g) *Example 7* is added.

4. The heading for paragraph (h) is revised.

5. The first sentence of paragraph (h)(1) is removed and two new sentences are added in its place.

The revisions and additions read as follows:

§ 1.1502-19 Excess loss accounts.

* * * * *

(b) * * *

(2) * * * (i) * * * As another example, if S redeems (or is treated as redeeming)

P's S stock and, as a result, an excess loss account is either increased or created in such redeemed stock, P takes into account such excess loss account under the rules of paragraph (b)(5) of this section.

* * * * *

(5) *Redemptions of member stock; treatment of excess loss account in redeemed stock*—(i) *In general.* In any case in which an amount received in redemption of S stock is treated as a distribution to P to which section 301 applies and such amount either increases or creates an excess loss account in the redeemed S stock, after adjusting such basis or excess loss account to reflect the application of section 301(c)(2), section 1059, § 1.1502-32, or any other applicable provision of the Internal Revenue Code or the regulations thereunder, such excess loss account is treated as income (ordinary income or gain) recognized on a disposition of the redeemed stock on the date of the redemption. Such income shall be taken into account by P under the provisions of this paragraph (b)(5).

(ii) *Inclusion of gain attributable to excess loss account in redeemed stock*—(A) *Amount taken into account on final inclusion date.* On the final inclusion date (as defined in § 1.302-5(b)(3)), P must include in income as ordinary income or gain the excess loss account in the redeemed stock, reduced by any amounts of such excess loss account that are taken into account pursuant to the provisions of paragraph (b)(5)(ii)(B) of this section.

(B) *Amount taken into account on accelerated income inclusion date.* (1) On an accelerated income inclusion date (as defined in paragraph (b)(5)(ii)(B)(2) of this section), P must include in income as ordinary income or gain the excess loss account of the redeemed stock to the extent of the lesser of—

(i) The amount of such excess loss account reduced by the amount of such excess loss account previously taken into account pursuant to this paragraph (b)(5)(ii); and

(ii) The amount of loss recognized on the disposition of stock of S that the group of which P is a member is permitted to take into account on such accelerated income inclusion date without regard to the application of § 1.337(d)-2T.

(2) An accelerated income inclusion date is a date on which P is permitted to take into account a loss recognized on a dispo-

sition of S stock without regard to the application of § 1.337(d)-2T.

(iii) *Application of other rules.* In addition to the rules set forth in this paragraph (b)(5), the rules of § 1.302-5(d) apply for purposes of determining the appropriate time to take into account any portion of an excess loss account in redeemed stock by treating P as the redeemed shareholder and S as the redeeming corporation. However, the rules of § 1.302-5(d) shall be applied by using the language “accelerated income inclusion date” instead of “accelerated loss inclusion date” each time that term appears.

(iv) *Statement to be filed with returns.* With or as part of the income tax return for the year in which P takes into account any income attributable to an excess loss account in redeemed stock, P shall provide a statement entitled “Inclusion of Income Attributable to Excess Loss Account in Redeemed Stock.” The statement shall specify the amount of the income that is taken into account on such return pursuant to this paragraph (b)(5) and shall identify the shares to which such amounts relate.

* * * * *

(g) * * *

Example 7. Redemption of member stock. (a) *Facts.* P directly owns all of the outstanding stock of S1 and S2. S1 and S2 each own 50 shares of S3's outstanding 100 shares of stock. P is the common parent of the consolidated group. S1's adjusted basis in the S3 stock is \$50. In Year 1, S3 redeems all of its stock from S1 for \$100. In Year 2, P sells all of its shares of S1 stock to an unrelated party.

(b) *Analysis.* In Year 1, because S1 actually and constructively owns 100 percent of stock of S3 immediately before and immediately after the redemption, the redemption is treated as a distribution to which section 301 applies. S3's distribution is an intercompany distribution under § 1.1502-13(f)(2)(ii) and excluded from S1's gross income. Under § 1.1502-32, S1's basis in S3's stock is reduced by the amount of the distribution, creating an excess loss account of \$50. Pursuant to paragraph (b)(5)(i) of this section, that excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption. That income, however, is not taken into account on such date. Instead, it is taken into account on the date on which S1 departs from the consolidated group as that date is the final inclusion date because, if the facts that exist at the end of that day had existed immediately after the redemption, the redemption would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(b)(3). Accordingly, S1 must include in its income as gain an amount equal to the excess loss account in the redeemed S3 stock.

(h) *Effective dates*—(1) *Application.* This section, except for the last sentence of paragraph (b)(2)(i), and paragraphs (b)(5) and

(g) *Example 7* of this section, applies with respect to determinations of the basis of (including an excess loss account in) the stock of a member in consolidated return years beginning on or after January 1, 1995. The last sentence of paragraph (b)(2)(i), and paragraphs (b)(5) and (g) *Example 7* of this section apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

David A. Mader,
*Acting Deputy Commissioner
of Internal Revenue.*

(Filed by the Office of the Federal Register on October 17, 2002, 8:45 a.m., and published in the issue of the Federal Register for October 18, 2002, 67 F.R. 64331)