Internal Revenue
bulletin

Bulletin No. 2005-15
April 11, 2005

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Ct. D. 2080, page 850.

Gross income; litigant's recovery includes attorney's contingent fee. The Supreme Court holds that when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. **Commissioner of Internal Revenue *v.* Banks.**

Rev. Rul. 2005–23, page 864.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2005.

T.D. 9190, page 855.

Final regulations under section 664 of the Code concern the ordering rule of regulations section 1.664–1(d). The regulations provide rules for characterizing the income distributions from charitable remainder trusts (CRTs) when the income is subject to different federal income tax rates. The regulations reflect changes made to income tax rates, including capital gains and certain dividends, by the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, and the Jobs and Growth Tax Relief Reconciliation Act of 2003.

T.D. 9191, page 854.

Final regulations amend regulations under section 163(d) of the Code to provide the rules relating to how and when taxpayers may elect to take qualified dividend income into account as investment income for purposes of calculating the deduction for investment income expense.

T.D. 9192, page 866.

Final regulations under section 1502 of the Code provide guidance concerning the determination of the tax attributes that are available for reduction and the method for reducing those attributes when a member of a consolidated group excludes discharge of indebtedness income from gross income under section 108.

T.D. 9193, page 862.

Final regulations under section 704 of the Code clarify that if section 704(c) property is sold for an installment obligation, the installment obligation is treated as the contributed property for purposes of applying sections 704(c) and 737. Likewise, if the contributed property is a contract, such as an option to acquire property, the property acquired pursuant to the contract is treated as the contributed property for these purposes.

Announcement 2005–25, page 891.

This document contains a correction to final regulations (T.D. 9187, 2005–13 I.R.B. 778) that disallow certain losses recognized on sales of subsidiary stock by members of a consolidated group.

EXEMPT ORGANIZATIONS

Announcement 2005–24, page 889.

A list is provided of organizations now classified as private foundations.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

T.D. 9188, page 883.
REG–147195–04, page 888.

Temporary and proposed regulations under section 6103 of the Code set forth changes to the list of items of return information that the IRS discloses to the Department of Commerce for the purpose of structuring censuses and national economic accounts and conducting related statistical activities authorized by law.

Rev. Proc. 2005–22, page 886.

Qualified mortgage bonds; mortgage credit certificates; national median gross income. Guidance is provided concerning the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f) of the Code. Rev. Proc. 2004–24 obsoleted.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section 1.—Tax Imposed

Ct. D. 2080

SUPREME COURT OF THE UNITED STATES

No. 03-892

COMMISSIONER OF INTERNAL REVENUE *v.* BANKS

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

January 24, 2005*

Syllabus

Respondent Banks settled his federal employment discrimination suit against a California state agency and respondent Banaitis settled his Oregon state case against his former employer, but neither included fees paid to their attorneys under contingent-fee agreements as gross income on their federal income tax returns. In each case petitioner Commissioner of Internal Revenue issued a notice of deficiency, which the Tax Court upheld. In Banks' case, the Sixth Circuit reversed in part, finding that the amount Banks paid to his attorney was not includable as gross income. In Banaitis' case, the Ninth Circuit found that because Oregon law grants attorneys a superior lien in the contingent-fee portion of any recovery, that part of Banaitis' settlement was not includable as gross income.

Held: When a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. Pp. 5–12.

(a) Two preliminary observations help clarify why this issue is of consequence. First, taking the legal expenses as miscellaneous itemized deductions would have been of no help to respondents because the Alternative Minimum Tax establishes a tax liability floor and does not allow such deductions. Second, the American Jobs Creation Act of 2004—which amended the Internal Revenue Code to allow a taxpayer, in computing adjusted gross income, to deduct attorney's fees such as those at issue—does not apply here because it was passed after these cases arose and is not retroactive. Pp. 5–6.

(b) The Code defines "gross income" broadly to include all economic gains not otherwise exempted. Under the anticipatory assignment of income doctrine, a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party, *e.g., Lucas v. Earl*, 281 U.S. 111, because gains should be taxed "to those who earn them," *id*., at 114. The doctrine is meant to prevent taxpayers from avoiding taxation through arrangements and contracts devised to prevent income from vesting in the one who earned it. *Id*., at 115. Because the rule is preventative and motivated by administrative and substantive concerns, this Court does not inquire whether any particular assignment has a discernible tax avoidance purpose. Pp. 6–7.

(c) The Court agrees with the Commissioner that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. In an ordinary case, attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. However, in the context of anticipatory assignments, where the assignor may not have dominion over the income at the moment of receipt, the question is whether the assignor retains dominion over the income-generating asset. Looking to such control preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits. In the case of a litigation recovery, the income-generating asset is the cause of action derived from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. Respondents' counterarguments are rejected. The legal claim's value may be speculative at the moment of the assignment, but the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. In these cases, the taxpayer retained control over the asset, diverted some of the income produced to another party, and realized a benefit by doing so. Also rejected is respondents' suggestion that the attorney-client relationship be treated as a sort of business partnership or joint venture for tax purposes. In fact, that relationship is a quintessential principal-agent relationship, for the client retains ultimate dominion and control over the underlying claim. The attorney can make tactical decisions without consulting the client, but the client still must determine whether to settle or proceed to judgment and make, as well, other critical decisions. The attorney is an agent who is duty bound to act in the principal's interests, and so it is appropriate to treat the full recovery amount as income to the principal. This rule applies regardless of whether the attorney-client contract or state law confers any special rights or protections on the attorney, so long as such protections do not alter the relationship's fundamental principal-agent character. The Court declines to comment on other theories proposed by respondents and their *amici*, which were not advanced in earlier stages of the litigation or examined by the Courts of Appeals. Pp. 7–10.

(d) This Court need not address Banks' contention that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee-shifting provisions, such as those applicable in his case brought under 42 U.S.C. Secs. 1981, 1983, and 2000(e) *et seq*. He settled his case, and the fee paid to his attorney was calculated based solely on the contingent-fee contract. There was no court-ordered fee award or any indication in his contract with his attorney or the settlement that the contingent fee paid was in lieu of statutory fees that might otherwise have been recovered. Also, the American Jobs Creation Act redresses the concern

* Together with No. 03–907, *Commissioner of Internal Revenue v. Banaitis*, on certiorari to the United States Court of Appeals for the Ninth Circuit.

for many, perhaps most, claims governed by fee-shifting statutes. P. 11.

No. 03–892, 345 F.3d 373; No. 03–907, 340 F.3d 1074, reversed and remanded.

KENNEDY, J., delivered the opinion of the Court, in which all other Members joined, except REHNQUIST, C.J., who took no part in the decision of the cases.

SUPREME COURT OF THE UNITED STATES

No. 03-892

COMMISSIONER OF INTERNAL REVENUE, PETITIONER *v.* JOHN W. BANKS, II

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 03–907

COMMISSIONER OF INTERNAL REVENUE, PETITIONER *v.* SIGITAS J. BANAITIS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

January 24, 2005

JUSTICE KENNEDY delivered the opinion of the Court.

The question in these consolidated cases is whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent-fee agreement is income to the plaintiff under the Internal Revenue Code, 26 U.S.C. Sec. 1 *et seq*. (2000 ed. and Supp. I). The issue divides the courts of appeals. In one of the instant cases, *Banks v. Commissioner*, 345 F.3d 373 (2003), the Court of Appeals for the Sixth Circuit held the contingent-fee portion of a litigation recovery is not included in the plaintiff's gross income. The Courts of Appeals for the Fifth and Eleventh Circuits also adhere to this view, relying on the holding, over Judge Wisdom's dissent, in *Cotnam v. Commissioner*, 263 F.2d 119, 125–126 (CA5 1959). *Srivastava v. Commissioner*, 220 F.3d 353, 363–365 (CA5 2000); *Foster v. United States*, 249 F.3d 1275, 1279–1280 (CA11 2001). In the other case under review, *Banaitis v. Commissioner*, 340 F.3d 1074 (2003), the Court of Appeals for the Ninth Circuit held that the portion of the recovery paid to the attorney as a contingent fee is excluded from the plaintiff's gross income if state law gives the plaintiff's attorney a special property interest in the fee, but not otherwise. Six Courts of Appeals have held the entire litigation recovery, including the portion paid to an attorney as a contingent fee, is income to the plaintiff. Some of these Courts of Appeals discuss state law, but little of their analysis appears to turn on this factor. *Raymond v. United States*, 355 F.3d 107, 113–116 (CA2 2004); *Kenseth v. Commissioner*, 259 F.3d 881, 883–884 (CA7 2001); *Baylin v. United States*, 43 F.3d 1451, 1454–1455 (CA Fed. 1995). Other Courts of Appeals have been explicit that the fee portion of the recovery is always income to the plaintiff regardless of the nuances of state law. *O'Brien v. Commissioner*, 38 T.C. 707, 712 (1962), aff'd, 319 F.2d 532 (CA3 1963) (*per curiam*); *Young v. Commissioner*, 240 F.3d 369, 377–379 (CA4 2001); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, 1313–1314 (CA10 2001). We granted certiorari to resolve the conflict. 541 U.S. 958 (2004).

We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits.

I

A. *Commissioner v. Banks*

In 1986, respondent John W. Banks, II, was fired from his job as an educational consultant with the California Department of Education. He retained an attorney on a contingent-fee basis and filed a civil suit against the employer in a United States District Court. The complaint alleged employment discrimination in violation of 42 U.S.C. Secs. 1981 and 1983, Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. Sec. 2000e *et seq*., and Cal. Govt. Code Ann. Sec. 12965 (West 1986). The original complaint asserted various additional claims under state law, but Banks later abandoned these. After trial commenced in 1990, the parties settled for $464,000. Banks paid $150,000 of this amount to his attorney pursuant to the fee agreement.

Banks did not include any of the $464,000 in settlement proceeds as gross income in his 1990 federal income tax return. In 1997 the Commissioner of Internal Revenue issued Banks a notice of deficiency for the 1990 tax year. The Tax Court upheld the Commissioner's determination, finding that all the settlement proceeds, including the $150,000 Banks had paid to his attorney, must be included in Banks' gross income.

The Court of Appeals for the Sixth Circuit reversed in part. 345 F.3d 373 (2003). It agreed the net amount received by Banks was included in gross income but not the amount paid to the attorney. Relying on its prior decision in *Estate of Clarks v. Commissioner,* 202 F.3d 854 (2000), the court held the contingent-fee agreement was not an anticipatory assignment of Banks' income because the litigation recovery was not already earned, vested, or even relatively certain to be paid when the contingent-fee contract was made. A contingent-fee arrangement, the court reasoned, is more like a partial assignment of income-producing property than an assignment of income. The attorney is not the mere beneficiary of the client's largess, but rather earns his fee through skill and diligence. 345 F.3d, at 384–385 (quoting *Estate of Clarks*, *supra*, at 857–858). This reasoning, the court held, applies whether or not state law grants the attorney any special property interest (*e.g.*, a superior lien) in part of the judgment or settlement proceeds.

B. *Commissioner v. Banaitis*

After leaving his job as a vice president and loan officer at the Bank of California in 1987, Sigitas J. Banaitis retained an attorney on a contingent-fee basis and brought suit in Oregon state court against the Bank of California and its successor in ownership, the Mitsubishi Bank. The complaint alleged that Mitsubishi Bank willfully interfered with Banaitis' employment contract, and that the Bank of California attempted to induce Banaitis to breach his fiduciary duties to customers

and discharged him when he refused. The jury awarded Banaitis compensatory and punitive damages. After resolution of all appeals and post-trial motions, the parties settled. The defendants paid $4,864,547 to Banaitis; and, following the formula set forth in the contingent-fee contract, the defendants paid an additional $3,864,012 directly to Banaitis' attorney.

Banaitis did not include the amount paid to his attorney in gross income on his federal income tax return, and the Commissioner issued a notice of deficiency. The Tax Court upheld the Commissioner's determination, but the Court of Appeals for the Ninth Circuit reversed. 340 F.3d 1074 (2003). In contrast to the Court of Appeals for the Sixth Circuit, the *Banaitis* court viewed state law as pivotal. Where state law confers on the attorney no special property rights in his fee, the court said, the whole amount of the judgment or settlement ordinarily is included in the plaintiff's gross income. *Id*., at 1081. Oregon state law, however, like the law of some other States, grants attorneys a superior lien in the contingent-fee portion of any recovery. As a result, the court held, contingent-fee agreements under Oregon law operate not as an anticipatory assignment of the client's income but as a partial transfer to the attorney of some of the client's property in the lawsuit.

II

To clarify why the issue here is of any consequence for tax purposes, two preliminary observations are useful. The first concerns the general issue of deductibility. For the tax years in question the legal expenses in these cases could have been taken as miscellaneous itemized deductions subject to the ordinary requirements, 26 U.S.C. Secs. 67–68 (2000 ed. and Supp. I), but doing so would have been of no help to respondents because of the operation of the Alternative Minimum Tax (AMT). For noncorporate individual taxpayers, the AMT establishes a tax liability floor equal to 26 percent of the taxpayer's "alternative minimum taxable income" (minus specified exemptions) up to $175,000, plus 28 percent of alternative minimum taxable income over $175,000. Secs. 55(a), (b) (2000 ed.). Alternative minimum taxable income, unlike ordinary gross income, does not allow any miscellaneous itemized deductions. Secs. 56(b)(1)(A)(i).

Second, after these cases arose Congress enacted the American Jobs Creation Act of 2004, 118 Stat. 1418. Section 703 of the Act amended the Code by adding Sec. 62(a)(19). *Id*., at 1546. The amendment allows a taxpayer, in computing adjusted gross income, to deduct "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination." *Ibid*. The Act defines "unlawful discrimination" to include a number of specific federal statutes, Secs. 62(e)(1) to (16), any federal whistle-blower statute, Sec. 62(e)(17), and any federal, state, or local law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship . . . or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law," Sec. 62(e)(18). *Id*., at 1547–1548. These deductions are permissible even when the AMT applies. Had the Act been in force for the transactions now under review, these cases likely would not have arisen. The Act is not retroactive, however, so while it may cover future taxpayers in respondents' position, it does not pertain here.

III

The Internal Revenue Code defines "gross income" for federal tax purposes as "all income from whatever source derived." 26 U.S.C. Sec. 61(a). The definition extends broadly to all economic gains not otherwise exempted. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429–430 (1955); *Commissioner v. Jacobson,* 336 U.S. 28, 49 (1949). A taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. *Lucas v. Earl*, 281 U.S. 111 (1930); *Commissioner v. Sunnen,* 333 U.S. 591, 604 (1948); *Helvering v. Horst*, 311 U.S. 112, 116–117 (1940). The rationale for the so-called anticipatory assignment of income doctrine is the principle that gains should be taxed "to those who earn them," *Lucas, supra*, at 114, a maxim we have called "the first principle of income taxation," *Commissioner v. Culbertson*, 337 U.S. 733, 739–740 (1949). The anticipatory assignment doctrine is meant to prevent taxpayers from avoiding taxation through "arrangements and contracts however skillfully devised to prevent [income] when paid from vesting even for a second in the man who earned it." *Lucas*, 281 U.S., at 115. The rule is preventative and motivated by administrative as well as substantive concerns, so we do not inquire whether any particular assignment has a discernible tax avoidance purpose. As *Lucas* explained, "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Ibid*.

Respondents argue that the anticipatory assignment doctrine is a judge-made antifraud rule with no relevance to contingent-fee contracts of the sort at issue here. The Commissioner maintains that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. We agree with the Commissioner.

In an ordinary case, attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. *Glenshaw Glass Co., supra*, at 431; see also *Commissioner v. Indianapolis Power & Light Co*., 493 U.S. 203, 209 (1990); *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394, 403 (1972). In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance, the question becomes whether the assignor retains dominion over the income-generating asset, because the taxpayer "who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Horst, supra*, at 116–117. See also *Lucas, supra*, at 114–115; *Helvering v. Eubank*, 311 U.S. 122, 124–125 (1940); *Sunnen, supra*, at 604. Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.

In the case of a litigation recovery, the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. We do not understand respondents to argue otherwise. Rather, respondents advance two counterarguments. First, they say that, in contrast to the bond coupons assigned in *Horst*, the value of a legal claim is speculative at the moment of assignment, and may be worth nothing at all. Second, respondents insist that the claimant's legal injury is not the only source of the ultimate recovery. The attorney, according to respondents, also contributes income-generating assets—effort and expertise—without which the claimant likely could not prevail. On these premises respondents urge us to treat a contingent-fee agreement as establishing, for tax purposes, something like a joint venture or partnership in which the client and attorney combine their respective assets—the client's claim and the attorney's skill—and apportion any resulting profits.

We reject respondents' arguments. Though the value of the plaintiff's claim may be speculative at the moment the fee agreement is signed, the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. *Lucas, supra; United States v. Bayse*, 410 U.S. 441, 445, 450–452 (1973). Though *Horst* involved an anticipatory assignment of a predetermined sum to be paid on a specific date, the holding in that case did not depend on ascertaining a liquidated amount at the time of assignment. In the cases before us, as in *Horst*, the taxpayer retained control over the income-generating asset, diverted some of the income produced to another party, and realized a benefit by doing so. As Judge Wesley correctly concluded in a recent case, the rationale of *Horst* applies fully to a contingent-fee contract. *Raymond v. United States*, 355 F.3d, at 115–116. That the amount of income the asset would produce was uncertain at the moment of assignment is of no consequence.

We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes. The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. Restatement (Second) of Agency Sec. 1, Comment *e* (1957) (hereinafter Restatement); ABA Model Rules of Professional Conduct Rule 1.3, Comments 1, 1.7 1 (2002). The client may rely on the attorney's expertise and special skills to achieve a result the client could not achieve alone. That, however, is true of most principal-agent relationships, and it does not alter the fact that the client retains ultimate dominion and control over the underlying claim. The control is evident when it is noted that, although the attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions. Even where the attorney exercises independent judgment without supervision by, or consultation with, the client, the attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party. Restatement Secs. 13, 39, 387.

The attorney is an agent who is duty bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal. In this respect Judge Posner's observation is apt: "[T]he contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable. *Kenseth*, 259 F.3d, at 883. In both cases a principal relies on an agent to realize an economic gain, and the gain realized by the agent's efforts is income to the principal. The portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income.

This rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship. Cf. Restatement Sec. 13, Comment *b*, and Sec. 14G, Comment *a* (an agency relationship is created where a principal assigns a chose in action to an assignee for collection and grants the assignee a security interest in the claim against the assignor's debtor in order to compensate the assignee for his collection efforts). State laws vary with respect to the strength of an attorney's security interest in a contingent fee and the remedies available to an attorney should the client discharge or attempt to defraud the attorney. No state laws of which we are aware, however, even those that purport to give attorneys an "ownership" interest in their fees, *e.g.*, 340 F.3d, at 1082–1083 (discussing Oregon law); *Cotnam*, 263 F.2d, at 125 (discussing Alabama law), convert the attorney from an agent to a partner.

Respondents and their *amici* propose other theories to exclude fees from income or permit deductibility. These suggestions include: (1) The contingent-fee agreement establishes a Subchapter K partnership under 26 U.S.C. Secs. 702 704, and 761, Brief for Respondent Banaitis in No. 03–907, p. 5–21; (2) litigation recoveries are proceeds from disposition of property, so the attorney's fee should be subtracted as a capital expense pursuant to Secs. 1001, 1012, and 1016, Brief for Association of Trial Lawyers of America as *Amicus Curiae* 23–28, Brief for Charles Davenport as *Amicus Curiae* 3–13; and (3) the fees are deductible reimbursed employee business expenses under Sec. 62(a)(2)(A) (2000 ed. and Supp. I), Brief for Stephen Cohen as *Amicus Curiae*. These arguments, it appears, are being presented for the first time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories. In addition, we do not reach the instance where a relator pursues a claim on behalf of the United States. Brief for Taxpayers Against Fraud Education Fund as *Amicus Curia*e 10–20.

IV

The foregoing suffices to dispose of Banaitis' case. Banks' case, however, involves a further consideration. Banks brought his claims under federal statutes that authorize fee awards to prevailing plaintiffs' attorneys. He contends that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee shifting provisions. See *Venegas v. Mitchell*, 495 U.S.

82, 86 (1990) (observing that statutory fees enable "plaintiffs to employ reasonably competent lawyers without cost to themselves if they prevail"). In the federal system statutory fees are typically awarded by the court under the lodestar approach, *Hensley v. Eckerhart*, 461 U.S. 424, 433 (1983), and the plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court-awarded attorney's fees can exceed a plaintiff's monetary recovery. See, *e.g.*, *Riverside v. Rivera*, 477 U.S. 561, 564–565 (1986) (compensatory and punitive damages of $33,350; attorney's fee award of $245,456.25). Treating the fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit. Furthermore, it is urged that treating statutory fee awards as income to plaintiffs would undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general.

We need not address these claims. After Banks settled his case, the fee paid to his attorney was calculated solely on the basis of the private contingent-fee contract. There was no court-ordered fee award, nor was there any indication in Banks' contract with his attorney, or in the settlement agreement with the defendant, that the contingent fee paid to Banks' attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover. Also, the amendment added by the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.

* * *

For the reasons stated, the judgments of the Courts of Appeals for the Sixth and Ninth Circuits are reversed, and the cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

THE CHIEF JUSTICE took no part in the decision of these cases.

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 163.—Interest

26 CFR 1.163(d)–1: Time and manner for making elections under the Omnibus Budget Reconciliation Act of 1993 and the Jobs and Growth Tax Relief Reconciliation Act of 2003.

T.D. 9191

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Time and Manner of Making §163(d)(4)(B) Election to Treat Qualified Dividend Income as Investment Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to an election that may be made by noncorporate taxpayers to treat qualified dividend income as investment income for purposes of calculating the deduction for investment interest. The regulations reflect changes to the law made by the Jobs and Growth Tax Relief Reconciliation Act of 2003. The regulations affect taxpayers making the election under section 163(d)(4)(B) to treat qualified dividend income as investment income.

DATES: *Effective Date*: These regulations are effective March 18, 2005.

Applicability Dates: For dates of applicability, see §1.163(d)–1(d).

FOR FURTHER INFORMATION CONTACT: Amy Pfalzgraf, (202) 622–4950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 163(d) of the Internal Revenue Code (Code). On August 5, 2004, temporary regulations (T.D. 9147, 2004–37 I.R.B. 461) were published in the **Federal Register** (69 FR 47364) relating to an election that may be made by noncorporate taxpayers to treat qualified dividend income as investment income for purposes of calculating the deduction for investment interest. A notice of proposed rulemaking (REG–171386–03, 2004–37 I.R.B. 477) cross-referencing the temporary regulations also was published in the **Federal Register** (69 FR 47395) on August 5, 2004. No comments in response to the notice of proposed rulemaking or requests to speak at a public hearing were received, and no hearing was held. This Treasury decision adopts the proposed regulations and removes the temporary regulations.

Special Analyses

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

Drafting Information

The principal author of these regulations is Amy Pfalzgraf of the Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

Part 1—INCOME TAXES

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

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

Par. 2. Section 1.163(d)–1 is revised to read as follows:

§1.163(d)–1 Time and manner for making elections under the Omnibus Budget Reconciliation Act of 1993 and the Jobs and Growth Tax Relief Reconciliation Act of 2003.

(a) *Description*. Section 163(d)(4)(B)(iii), as added by section 13206(d) of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66, 107 Stat. 467), allows an electing taxpayer to take all or a portion of certain net capital gain attributable to dispositions of property held for investment into account as investment income. Section 163(d)(4)(B), as amended by section 302(b) of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108–27, 117 Stat. 762), allows an electing taxpayer to take all or a portion of qualified dividend income, as defined in section 1(h)(11)(B), into account as investment income. As a consequence, the net capital gain and qualified dividend income taken into account as investment income under these elections are not eligible to be taxed at the capital gains rates. An election may be made for net capital gain recognized by noncorporate taxpayers during any taxable year beginning after December 31, 1992. An election may be made for qualified dividend income received by noncorporate taxpayers during any taxable year beginning after December 31, 2002, but before January 1, 2009.

(b) *Time and manner for making the elections*. The elections for net capital gain and qualified dividend income must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized or the qualified dividend income is received. The elections are to be made on Form 4952, "*Investment Interest Expense Deduction*," in accordance with the form and its instructions.

(c) *Revocability of elections*. The elections described in this section are revocable with the consent of the Commissioner.

(d) *Effective date*. The rules set forth in this section regarding the net capital gain election apply beginning December 12, 1996. The rules set forth in this section regarding the qualified dividend income election apply to any taxable year beginning after December 31, 2002, but before January 1, 2009.

Par. 3. Section 1.163–1T is removed.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved March 10, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 17, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 18, 2005, 70 F.R. 13100)

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 664.—Charitable Remainder Trusts

26 CFR 1.664–1: Charitable remainder trusts.

T.D. 9190

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Charitable Remainder Trusts; Application of Ordering Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the ordering rules of section 664(b) of the Internal Revenue Code for characterizing distributions from charitable remainder trusts (CRTs). The fi-

nal regulations reflect changes made to income tax rates, including the rates applicable to capital gains and certain dividends, by the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. The final regulations provide guidance needed to comply with these changes and affect CRTs and their beneficiaries.

DATES: *Effective Date*: These regulations are effective on March 16, 2005.

Applicability Dates: For dates of applicability, see §1.664–1(d)(1)(ix).

FOR FURTHER INFORMATION CONTACT: Theresa M. Melchiorre, (202) 622–7830 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 664(b) of the Internal Revenue Code. On November 20, 2003, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–110896–98, 2003–2 C.B. 1226) in the **Federal Register** (68 FR 65419). The public hearing scheduled for March 9, 2004, was cancelled because no requests to speak were received. Several written comments responding to the notice of proposed rulemaking were received. After consideration of the written comments, the proposed regulations are adopted as revised by this Treasury decision. The revisions and a summary of the comments are discussed below.

The proposed regulations reflected changes made to income tax rates, including the rates applicable to capital gains and certain dividends, by the Taxpayer Relief Act of 1997 (TRA), Public Law 105–34 (111 Stat. 788), and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108–27 (117 Stat. 752). These changes affect the ordering rules of section 664(b) for characterizing distributions from CRTs.

Prior to the TRA, long-term capital gains were generally subject to the same Federal income tax rate. The TRA provided, however, that gain from certain types of long-term capital assets would be subject to different Federal income tax rates. Accordingly, after May 6, 1997, a CRT could have at least three classes of long-term capital gains and losses: a class for 28-percent gain (gains and losses from collectibles and section 1202 gains); a class for unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and a class for all other long-term capital gain. In addition, the TRA provided that qualified 5-year gain (as defined in section 1(h)(9) prior to amendment by the JGTRRA) would be subject to reduced capital gains tax rates under certain circumstances for certain taxpayers. For taxpayers subject to a 10-percent capital gains tax rate, qualified 5-year gain would be taxed at an 8-percent capital gains tax rate effective for taxable years beginning after December 31, 2000. For taxpayers subject to a 20-percent capital gains tax rate, qualified 5-year gain would be taxed at an 18-percent capital gains tax rate provided the holding period for the property from which the gain was derived began after December 31, 2000. As a result, a CRT could also have a class for qualified 5-year gain.

Prior to the JGTRRA, a CRT's ordinary income was generally subject to the same Federal income tax rate. The JGTRRA provided, however, that qualified dividend income as defined in section 1(h)(11) would be subject to the Federal income tax rate applicable to the class for all other long-term capital gain. As a result, after December 31, 2002, a CRT could have a qualified dividend income class that would be subject to a different Federal income tax rate than that applicable to the CRT's other types of ordinary income. In addition, the JGTRRA provided that qualified 5-year gain would cease to exist after May 5, 2003, but that it would return after December 31, 2008.

In response to the changes made by the TRA and the technical corrections to the TRA made by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 685), the IRS issued guidance on the treatment of capital gains under section 664(b)(2) in Notice 98–20, 1998–1 C.B. 776, as modified by Notice 99–17, 1999–1 C.B. 871. The proposed regulations incorporated the guidance provided in Notice 98–20 and Notice 99–17. In addition, the proposed regulations provided additional guidance on the treatment of qualified dividend income under section 664(b)(1) and the treatment of a class of income that temporarily ceases to exist, like the qualified 5-year gain class.

Explanation of Provisions

The proposed regulations provided that trusts must maintain separate classes within a category of income when two classes are only temporarily subject to the same tax rate (for example, if the current tax rate applicable to one class sunsets in a future year). In the preamble to the proposed regulations, comments were requested on the degree of administrative burden and potential tax benefit or detriment of this requirement. Only one comment was received in response to this request. The commentator pointed out that maintaining a class during a temporary period of suspension could be favorable to taxpayers in one situation and unfavorable in another. For example, maintaining the qualified 5-year gain class during a temporary period of suspension would be advantageous because when the class is again in existence, gain distributed from the class probably would be taxed at a rate lower than the rates applicable to other classes of long-term capital gain. On the other hand, if the 28-percent long-term capital gain class is taxed at 15 percent during a temporary period, gain distributed from that class after the expiration of that temporary period is likely to be taxed at a rate higher than the rates applicable to other classes of long-term capital gain.

The IRS and Treasury Department continue to believe that it is appropriate for CRTs to maintain separate classes for income only temporarily taxed at the same rate, and no comment received indicated that this requirement would be unduly burdensome. Therefore, this requirement remains unchanged in the final regulations.

The proposed regulations provided that, to be eligible for inclusion in the class of qualified dividend income, dividends must meet the definition of section 1(h)(11) and must be received by the trust after December 31, 2002. Several commentators suggested that the final regulations should provide that undistributed dividends received by a CRT prior to January 1, 2003, that would otherwise meet the definition of

qualified dividends under section 1(h)(11), be treated as qualified dividends.

Subsequent to the issuance of the proposed regulations, a technical correction was made to the JGTRRA by the Working Families Tax Relief Act of 2004, Public Law 108–311 (118 Stat. 1166), to provide that dividends received by a trust on or before December 31, 2002, shall not be treated as qualified dividend income as defined in section 1(h)(11). Accordingly, this suggestion has not been adopted in the final regulations.

The proposed regulations provided that, in netting capital gains and losses, a net short-term capital loss is first netted against the net long-term capital gain in each class before the long-term capital gains and losses in each class are netted against each other. One commentator suggested that this netting rule be revised to provide that the gains and losses of the long-term capital gain classes be netted prior to netting short-term capital loss against any class of long-term capital gain.

The IRS and Treasury Department believe that the netting rules for CRTs should be consistent with the netting rules applicable generally to other noncorporate taxpayers. Accordingly, the final regulations adopt this suggested change.

The proposed regulations provided that items of income within the ordinary income and capital gains categories are assigned to different classes based on the Federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the CRT. One commentator suggested that the assignment of items of income to different classes in the year the items are required to be taken into account by the CRT should be based on the Federal income tax rate that is likely to apply to that item in the hands of the recipient (for example, depending on the recipient's marginal income tax rate bracket) in the year in which the item is distributed.

The final regulations do not adopt this change. It is not feasible in many instances for trustees to determine the tax bracket of beneficiaries. The IRS and Treasury Department believe that the assignment of an item to a particular class should be based upon the tax rate applicable to each class when the item is received by the CRT, and not the various tax rates applicable to the classes at the time of a distribution to the beneficiary.

The proposed regulations provided that the determination of the tax character of amounts distributed by a CRT shall be made as of the end of the taxable year of the CRT. One commentator recommended that the language in the proposed regulations be reworded to make it clear that this rule applies to all distributions made by the CRT to recipients throughout the calendar year. In response to the comment, the second sentence in §1.664–1(d)(1)(ii)(*a*) is revised in the final regulations to read, "[t]he determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the trust shall be made as of the end of that taxable year."

The proposed regulations provided that the annuity or unitrust recipient is taxed on the distribution from the CRT based on the tax rates applicable in the year of the distribution to the classes of income that are deemed distributed from the trust. One commentator suggested that the language in the proposed regulations be reworded to make it clear that the tax rates applicable to a distribution or deemed distribution from a CRT to a recipient are the tax rates applicable to the classes of income from which the distribution is derived in the year of distribution, and not the tax rates applicable to the income in the year it is received by the CRT. This suggestion has been adopted. In the final regulations, the third sentence in §1.664–1(d)(1)(ii)(*a*) is revised to read as follows:

> The tax rate or rates to be used in computing the recipient's tax on the distribution shall be the tax rates that are applicable, in the year in which the distribution is required to be made, to the classes of income deemed to make up that distribution, and not the tax rates that are applicable to those classes of income in the year the income is received by the trust.

One commentator suggested that a cross-reference to §1.664–1(d)(4) should be made following the above sentence. This suggestion has not been adopted because the IRS and Treasury Department do not believe that a cross reference is needed. Section 1.664–1(d)(1)(ii)(*a*) confirms that a class of income will be taxed to the beneficiary at the tax rate applicable to that class in the year the distribution is made. Section 1.664–1(d)(4) identifies the year of the distribution.

One commentator proposed that the final regulations specifically address the treatment of municipal bond income and the effect of the alternative minimum tax (AMT) provisions and section 469 on CRT income. The final regulations do not address these issues, because the IRS and Treasury Department believe they are beyond the scope of these regulations. These regulations are intended to address only the income tax rates applicable to classes of income and the order in which those classes of income are to be applied to determine the character of a distribution in the hands of a recipient. The issues raised by the commentator are more appropriately addressed in separate guidance.

One commentator requested clarification of whether the ordering rules in the proposed regulations apply to a CRT that has lost its tax-exempt status under section 664(c) in the year income is distributed. Section 1.664–1(d)(1)(ii) of the proposed regulations provides that the categories and classes of income determined under §1.664–1(d)(1)(i) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient, irrespective of whether the trust is exempt from taxation under section 664(c) for the year of the distribution. The final regulations retain this provision.

One commentator recommended that the IRS provide a detailed worksheet that would include all of the possible classes of income a CRT could have so that the trustees can track a CRT's income from year to year. Because the types of income that each CRT may have can vary widely, the IRS and Treasury Department have determined that such a worksheet is not administratively feasible at this time.

One commentator recommended that a provision similar to §1.664–1(d)(4)(ii) be added to the final regulations to permit the trustee to make corrections when the trustee has made incorrect distributions as a result of mistakes in fiduciary accounting practices, suggesting that such a provision would allow the CRT to receive the benefit of any correction in the year during which the correction is made. The IRS and Treasury Department believe that the proper method to remedy such errors is the filing of amended returns, rather than a current year adjustment and, therefore, such a pro-

vision is not included in the final regulations.

One commentator requested that examples addressing the following situations be provided in the final regulations:

Situation 1. The end result of a short-term capital loss and a combination of long-term capital gains and losses that net to a long-term capital loss;

Situation 2. The end result when a class of income has a net-loss amount that is carried forward without affecting the tax character of distributions;

Situation 3. The applicability of the passive loss rules under section 469 to the ordering rules of section 664(b);

Situation 4. The applicability of the alternative minimum tax (AMT) provisions under section 55 to the ordering rules under section 664(b); and

Situation 5. The treatment of the distribution of qualified 5-year gain between January 1, 2004, and December 31, 2008.

In response to this request, Examples 4 and 5 have been added to the final regulations. Example 4 addresses situations 1 and 2. Example 5 addresses situation 5. Examples will not be added to address situations 3 and 4 because they involve issues beyond the scope of these final regulations.

Special Analyses

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

Drafting Information

The principal author of these regulations is Theresa M. Melchiorre, Office of Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.664–1 is amended as follows:

1. Paragraph (d)(1) is revised.

2. Paragraph (d)(2) is amended by:

a. Removing the language "or to corpus (determined under subparagraph (1)(i) of this paragraph)" in the first sentence and adding "(determined under paragraph (d)(1)(i)(*a*) of this section) or to corpus" in its place.

b. Removing the language "subparagraph (1)(i)(c) of this paragraph" from the fifth sentence and adding "paragraph (d)(1)(i)(*a*)(*3*) of this section" in its place.

c. Removing the language "or to corpus in the categories described in subparagraph (1) of this paragraph" from the last sentence and adding "described in paragraph (d)(1)(i)(*a*) of this section or to corpus" in its place.

3. Paragraph (e)(1) is amended by removing the language "paragraph (d)(1)" from the first sentence and adding "paragraph (d)(1)(i)(*a*)" in its place.

The revision reads as follows:

§1.664–1 Charitable remainder trusts.

* * * * *

(d) *Treatment of annual distributions to recipients*—(1) *Character of distributions*—(i) *Assignment of income to categories and classes at the trust level*. (*a*) A trust's income, including income includible in gross income and other income, is assigned to one of three categories in the year in which it is required to be taken into account by the trust. These categories are—

(*1*) Gross income, other than gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the ordinary income category);

(*2*) Gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the capital gains category); and

(*3*) Other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Internal Revenue Code).

(*b*) Items within the ordinary income and capital gains categories are assigned to different classes based on the Federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the trust. For example, for a trust with a taxable year ending December 31, 2004, the ordinary income category may include a class of qualified dividend income as defined in section 1(h)(11) and a class of all other ordinary income, and the capital gains category may include separate classes for short-term and long-term capital gains and losses, such as a short-term capital gain class, a 28-percent long-term capital gain class (gains and losses from collectibles and section 1202 gains), an unrecaptured section 1250 long-term capital gain class (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation), a qualified 5-year long-term capital gain class as defined in section 1(h)(9) prior to amendment by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108–27 (117 Stat. 752), and an all other long-term capital gain class. After items are assigned to a class, the tax rates may change so that items in two or more classes would be taxed at the same rate if distributed to the recipient during a particular year. If the changes to the tax rates are permanent, the undistributed items in those classes are combined into one class. If, however, the changes to the tax rates are only temporary (for example, the new rate for one class will sunset in a future year), the classes are kept separate.

(ii) *Order of distributions*. (*a*) The categories and classes of income (determined under paragraph (d)(1)(i) of this section) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient irrespective of whether the trust is exempt from taxation under section 664(c) for the year of the distribution. The determination of the character of amounts distributed or

deemed distributed at any time during the taxable year of the trust shall be made as of the end of that taxable year. The tax rate or rates to be used in computing the recipient's tax on the distribution shall be the tax rates that are applicable, in the year in which the distribution is required to be made, to the classes of income deemed to make up that distribution, and not the tax rates that are applicable to those classes of income in the year the income is received by the trust. The character of the distribution in the hands of the annuity or unitrust recipient is determined by treating the distribution as being made from each category in the following order:

(*1*) First, from ordinary income to the extent of the sum of the trust's ordinary income for the taxable year and its undistributed ordinary income for prior years.

(*2*) Second, from capital gain to the extent of the trust's capital gains determined under paragraph (d)(1)(iv) of this section.

(*3*) Third, from other income to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years.

(*4*) Finally, from trust corpus (with corpus defined for this purpose as the net fair market value of the trust assets less the total undistributed income (but not loss) in paragraphs (d)(1)(i)(*a*)(*1*) through (*3*) of this section).

(*b*) If the trust has different classes of income in the ordinary income category, the distribution from that category is treated as being made from each class, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. If the trust has different classes of net gain in the capital gains category, the distribution from that category is treated as being made first from the short-term capital gain class and then from each class of long-term capital gain, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. If two or more classes within the same category are subject to the same current tax rate, but at least one of those classes will be subject to a different tax rate in a future year (for example, if the current rate sunsets), the order of that class in relation to other classes in the category with the same current tax rate is determined based on the future rate or rates applicable to those classes. Within each category, if there is more than one type of income in a class, amounts treated as distributed from that class are to be treated as consisting of the same proportion of each type of income as the total of the current and undistributed income of that type bears to the total of the current and undistributed income of all types of income included in that class. For example, if rental income and interest income are subject to the same current and future Federal income tax rate and, therefore, are in the same class, a distribution from that class will be treated as consisting of a proportional amount of rental income and interest income.

(iii) *Treatment of losses at the trust level*—(*a*) *Ordinary income category*. A net ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years that is assigned to the same class as the loss. Any excess loss is then used to reduce the current and undistributed ordinary income from other classes, in turn, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. If any of the loss exists after all the current and undistributed ordinary income from all classes has been offset, the excess is carried forward indefinitely to reduce ordinary income for future years and retains its class assignment. For purposes of this section, the amount of current income and prior years' undistributed income shall be computed without regard to the deduction for net operating losses provided by section 172 or 642(d).

(*b*) *Other income category*. A net loss in the other income category for the current year is used to reduce undistributed income in this category for prior years and any excess is carried forward indefinitely to reduce other income for future years.

(iv) *Netting of capital gains and losses at the trust level*. Capital gains of the trust are determined on a cumulative net basis under the rules of this paragraph (d)(1) without regard to the provisions of section 1212. For each taxable year, current and undistributed gains and losses within each class are netted to determine the net gain or loss for that class, and the classes of capital gains and losses are then netted against each other in the following order. First, a net loss from a class of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) is used to offset net gain from each other class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Second, either —

(*a*) A net loss from all the classes of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) is used to offset any net gain from the class of short-term capital gain and loss; or

(b) A net loss from the class of short-term capital gain and loss is used to offset any net gain from each class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate.

(v) *Carry forward of net capital gain or loss by the trust*. If, at the end of a taxable year, a trust has, after the application of paragraph (d)(1)(iv) of this section, any net loss or any net gain that is not treated as distributed under paragraph (d)(1)(ii)(*a*)(*2*) of this section, the net gain or loss is carried over to succeeding taxable years and retains its character in succeeding taxable years as gain or loss from its particular class.

(vi) *Special transitional rules*. To be eligible to be included in the class of qualified dividend income, dividends must meet the definition of section 1(h)(11) and must be received by the trust after December 31, 2002. Long-term capital gain or loss properly taken into account by the trust before January 1, 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss properly taken into account by the trust on or after January 1, 1997, and before May 7, 1997, if not treated as distributed in 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss (other than 28-percent gain (gains and losses from collectibles and section 1202 gains), unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all

depreciation), and qualified 5-year gain as defined in section 1(h)(9) prior to amendment by JGTRRA), properly taken into account by the trust before January 1, 2003, and distributed during 2003 is treated as if it were properly taken into account by the trust after May 5, 2003. Long-term capital gain or loss (other than 28-percent gain, unrecaptured section 1250 gain, and qualified 5-year gain), properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if not treated as distributed during 2003, is included in the class of all other long-term capital gain. Qualified 5-year gain properly taken into account by the trust after December 31, 2000, and before May 6, 2003, if not treated as distributed by the trust in 2003 or a prior year, must be maintained in a separate class within the capital gains category until distributed. Qualified 5-year gain properly taken into account by the trust before January 1, 2003, and deemed distributed during 2003 is subject to the same current tax rate as deemed distributions from the class of all other long-term capital gain realized by the trust after May 5, 2003. Qualified 5-year gain properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if treated as distributed by the trust in 2003, is subject to the tax rate in effect prior to the amendment of section 1(h)(9) by JGTRRA.

(vii) *Application of section 643(a)(7).* For application of the anti-abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see §1.643(a)–8.

(viii) *Examples.* The following examples illustrate the rules in this paragraph (d)(1):

Example 1. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2003. The annual annuity amount is $100. X's income for the 2003 tax year is as follows:

Interest income	$80
Qualified dividend income	50
Capital gains and losses	0
Tax-exempt income	0

(ii) In 2003, the year this income is received by the trust, qualified dividend income is subject to a different rate of Federal income tax than interest income and is, therefore, a separate class of income in the ordinary income category. The annuity amount is deemed to be distributed from the classes within the ordinary income category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Because during 2003 qualified dividend income is taxed at a lower rate than interest income, the interest income is deemed distributed prior to the qualified dividend income. Therefore, in the hands of the recipient, the 2003 annuity amount has the following characteristics:

Interest income	$80
Qualified dividend income	20

(iii) The remaining $30 of qualified dividend income that is not treated as distributed to the recipient in 2003 is carried forward to 2004 as undistributed qualified dividend income.

Example 2. (i) The facts are the same as in *Example 1*, and at the end of 2004, X has the following classes of income:

Interest income class	$ 5
Qualified dividend income class	40
($10 from 2004 and $30 carried forward from 2003)	
Net short-term capital gain class	15
Net long-term capital loss in 28-percent class	(325)
Net long-term capital gain in unrecaptured section 1250 gain class	175
Net long-term capital gain in all other long-term capital gain class	350

(ii) In 2004, gain in the unrecaptured section 1250 gain class is subject to a 25-percent Federal income tax rate, and gain in the all other long-term capital gain class is subject to a lower rate. The net long-term capital loss in the 28-percent gain class is used to offset the net capital gains in the other classes of long-term capital gain and loss, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The $325 net loss in the 28-percent gain class reduces the $175 net gain in the unrecaptured section 1250 gain class to $0. The remaining $150 loss from the 28-percent gain class reduces the $350 gain in the all other long-term capital gain class to $200. As in *Example 1*, qualified dividend income is taxed at a lower rate than interest income during 2004. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2004 annuity amount has the following characteristics:

Interest income	$ 5
Qualified dividend income	40
Net short-term capital gain	15
Net long-term capital gain in all other long-term capital gain class	40

(iii) The remaining $160 gain in the all other long-term capital gain class that is not treated as distributed to the recipient in 2004 is carried forward to 2005 as gain in that same class.

Example 3. (i) The facts are the same as in *Examples 1* and *2*, and at the end of 2005, X has the following classes of income:

Interest income class	$ 5
Qualified dividend income class	20
Net loss in short-term capital gain class	(50)
Net long-term capital gain in 28-percent gain class	10
Net long-term capital gain in unrecaptured section 1250 gain class	135
Net long-term capital gain in all other long-term capital gain class (carried forward from 2004)	160

(ii) There are no long-term capital losses to net against the long-term capital gains. Thus, the net short-term capital loss is used to offset the net capital gains in the classes of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The $50 net short-term loss reduces the $10 net gain in the 28-percent gain class to $0. The remaining $40 net loss reduces the $135 net gain in the unrecaptured section 1250 gain class to $95. As in *Examples 1* and *2*, during 2005, qualified dividend income is taxed at a lower rate than interest income; gain in the unrecaptured section 1250 gain class is taxed at 25 percent; and gain in the all other long-term capital gain class is taxed at a rate lower than 25 percent. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Therefore, in the hands of the recipient, the 2005 annuity amount has the following characteristics:

Interest income	$ 5
Qualified dividend income	20
Unrecaptured section 1250 gain	75

(iii) The remaining $20 gain in the unrecaptured section 1250 gain class and the $160 gain in the all other long-term capital gain class that are not treated as distributed to the recipient in 2005 are carried forward to 2006 as gains in their respective classes.

Example 4. (i) The facts are the same as in *Examples 1*, *2* and *3*, and at the end of 2006, X has the following classes of income:

Interest income class	$ 95
Qualified dividend income class	10
Net loss in short-term capital gain class	(20)
Net long-term capital loss in 28-percent class	(350)
Net long-term capital gain in unrecaptured section 1250 gain class (carried forward from 2005)	20
Net long-term capital gain in all other long-term capital gain class (carried forward from 2005)	160

(ii) A net long-term capital loss in one class is used to offset the net capital gains in the other classes of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The $350 net loss in the 28-percent gain class reduces the $20 net gain in the unrecaptured section 1250 gain class to $0. The remaining $330 net loss reduces the $160 net gain in the all other long-term capital gain class to $0. As in *Examples 1*, *2* and *3*, during 2006, qualified dividend income is taxed at a lower rate than interest income. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2006 annuity amount has the following characteristics:

Interest income	$95
Qualified dividend income	5

(iii) The remaining $5 of qualified dividend income that is not treated as distributed to the recipient in 2006 is carried forward to 2007 as qualified dividend income. The $20 net loss in the short-term capital gain class and the $170 net loss in the 28-percent gain class are carried forward to 2007 as net losses in their respective classes.

Example 5. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2002. The annual annuity amount is $100. Except for qualified 5-year gain of $200 realized before May 6, 2003, but not distributed, X has no other gains or losses carried over from former years. X's income for the 2007 tax year is as follows:

Interest income class	$10
Net gain in short-term capital gain class	5
Net long-term capital gain in 28-percent gain class	5
Net long-term capital gain in unrecaptured section 1250 gain class	10
Net long-term capital gain in all other long-term capital gain class	10

(ii) The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In 2007, gains distributed to a recipient from both the qualified 5-year gain class and the all other long-term capital gains class are taxed at a 15/5 percent tax rate. Since after December 31, 2008, gains distributed from the qualified 5-year gain class will be taxed at a lower rate than gains distributed from the other classes of long-term capital gain and loss, distributions from the qualified 5-year gain class are made after distributions from the other classes of long-term capital gain and loss. In the hands of the recipient, the 2007 annuity amount has the following characteristics:

Interest income	$10
Short-term capital gain	5
28-percent gain	5
Unrecaptured section 1250 gain	10
All other long-term capital gain	10
Qualified 5-year gain (taxed as all other long-term capital gain)	60

(iii) The remaining $140 of qualified 5-year gain that is not treated as distributed to the recipient in 2007 is carried forward to 2008 as qualified 5-year gain.

(ix) *Effective dates*. The rules in this paragraph (d)(1) that require long-term capital gains to be distributed in the following order: first, 28-percent gain (gains and losses from collectibles and section 1202 gains); second, unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and then, all other long-term capital gains are applicable for taxable years ending on or after December 31, 1998. The rules in this paragraph (d)(1) that provide for the netting of capital gains and losses are applicable for taxable years ending on or after December 31, 1998. The rule in the second sentence of paragraph (d)(1)(vi) of this section is applicable for taxable years ending on or after December 31, 1998. The rule in the third sentence of paragraph (d)(1)(vi) of this section is applicable for distributions made in taxable years ending on or after December 31, 1998. All other provisions of this paragraph (d)(1) are applicable for taxable years ending after November 20, 2003.

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved March 10, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 15, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 16, 2005, 70 F.R. 12793)

Section 704.—Partner's Distributive Share

26 CFR 1.704–3: Contributed property.

T.D. 9193

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Section 704(c), Installment Obligations and Contributed Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under sections 704(c) and 737 relating to the tax treatment of installment obligations and property acquired pursuant to a contract. The regulations affect partners and partnerships and provide guidance necessary to comply with the law.

DATES: *Effective Date:* These regulations are effective November 23, 2003.

Applicability Date: For dates of applicability, see §§1.704–3(f), 1.704–4(g) and 1.737–5.

FOR FURTHER INFORMATION CONTACT: Christopher L. Trump, (202) 622–3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under sections 704 and 737. On November 24, 2003, a notice of proposed rulemaking (REG–160330–02, 2003–2 C.B. 1230) relating to the tax treatment of installment obligations and property acquired pursuant to a contract under sections 704(c) and 737 was published in the **Federal Register** (68 FR 65864). A notice of correction was published in the **Federal Register** (69 FR 5797) on February 6, 2004. No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested, and accordingly, no hearing was held. This Treasury decision adopts the language of the proposed regulations without change.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order

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

Drafting Information

The principal author of these regulations is Christopher L. Trump of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.704–3 is amended as follows:

1. The paragraph heading for (a)(8) is revised.

2. The text of paragraph (a)(8) is redesignated as paragraph (a)(8)(i).

3. A paragraph heading for newly designated paragraph (a)(8)(i) is added.

4. The first sentence of newly designated paragraph (a)(8)(i) is amended by removing the language "in which no gain or loss is recognized".

5. Paragraphs (a)(8)(ii) and (a)(8)(iii) are added.

6. Paragraph (f) is amended by:

a. Revising the paragraph heading.

b. Amending the first sentence of paragraph (f) by removing the language "of paragraph (a)(11)" and adding "of paragraphs (a)(8)(ii), (a)(8)(iii) and (a)(11)" in its place.

c. Adding two sentences at the end of paragraph (f).

The revisions and additions read as follows:

§1.704–3 Contributed property.

(a) * * *

(8) *Special rules*—(i) *Disposition in a nonrecognition transaction*. * * *

(ii) *Disposition in an installment sale*. If a partnership disposes of section 704(c) property in an installment sale as defined in section 453(b), the installment obligation received by the partnership is treated as the section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property.

(iii) *Contributed contracts*. If a partner contributes to a partnership a contract that is section 704(c) property, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, then the acquired property is treated as the section 704(c) property with the same amount of built-in gain or loss as the contract (with appropriate adjustments for any gain or loss recognized on the acquisition). For this purpose, the term contract includes, but is not limited to, options, forward contracts, and futures contracts. The allocation method for the acquired property must be consistent with the allocation method chosen for the contributed contract.

* * * * *

(f) *Effective dates*. * * * Paragraph (a)(8)(ii) applies to installment obligations received by a partnership in exchange for section 704(c) property on or after November 24, 2003. Paragraph (a)(8)(iii) applies to property acquired on or after November 24, 2003, by a partnership pursuant to a contract that is section 704(c) property.

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

1. The paragraph heading for (d)(1) is revised.

2. The text of paragraph (d)(1) is redesignated as paragraph (d)(1)(i).

3. A paragraph heading for newly designated paragraph (d)(1)(i) is added.

4. Paragraphs (d)(1)(ii) and (d)(1)(iii) are added.

5. Revising paragraph (g).

The revisions and additions read as follows:

§1.704–4 Distribution of contributed property.

* * * * *

(d) *Special rules*—(1) *Nonrecognition transactions, installment obligations and contributed contracts*— (i) *Nonrecognition transactions*. * * *

(ii) *Installment obligations*. An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the installment obligation received is treated as section 704(c) property under §1.704–3(a)(8). See §1.737–2(d)(3) for a similar rule in the context of section 737.

(iii) *Contributed contracts*. Property acquired by the partnership pursuant to a contract that is section 704(c) property is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section, to the extent that the acquired property is treated as section 704(c) property under §1.704–3(a)(8). See §1.737–2(d)(3) for a similar rule in the context of section 737.

* * * * *

(g) *Effective dates*. This section applies to distributions by a partnership to a partner on or after January 9, 1995, except that paragraphs (d)(1)(ii) and (iii) apply to distributions by a partnership to a partner on or after November 24, 2003.

Par. 4. Section 1.737–2 is amended as follows:

1. The paragraph heading for (d)(3) is revised.

2. The text of paragraph (d)(3) is redesignated (d)(3)(i).

3. A paragraph heading for newly designated (d)(3)(i) is added.

4. Paragraphs (d)(3)(ii) and (d)(3)(iii) are added.

§1.737–2 Exceptions and special rules.

* * * * *

(d) * * *

(3) *Nonrecognition transactions, installment sales and contributed contracts*—(i) *Nonrecognition transactions*. * * *

(ii) *Installment sales*. An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the installment obligation received is treated as section 704(c) property under §1.704–3(a)(8). See §1.704–4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(iii) *Contributed contracts*. Property acquired by a partnership pursuant to a contract that is section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the acquired property is treated as section 704(c) property under §1.704–3(a)(8). See §1.704–4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

* * * * *

Par. 5. Section 1.737–5 is revised to read as follows:

§1.737–5 Effective dates.

Sections 1.737–1, 1.737–2, 1.737–3, and 1.737–4 apply to distributions by a partnership to a partner on or after January 9, 1995, except that §1.737–2(d)(3)(ii) and (iii) apply to distributions by a partnership to a partner on or after November 24, 2003.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved March 15, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 21, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 22, 2005, 70 F.R. 14394)

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2005.

Rev. Rul. 2005–23

This revenue ruling provides various prescribed rates for federal income tax purposes for April 2005 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2005–23 TABLE 1

Applicable Federal Rates (AFR) for April 2005

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	3.35%	3.32%	3.31%	3.30%
110% AFR	3.68%	3.65%	3.63%	3.62%
120% AFR	4.02%	3.98%	3.96%	3.95%
130% AFR	4.37%	4.32%	4.30%	4.28%

REV. RUL. 2005–23 TABLE 1

Applicable Federal Rates (AFR) for April 2005 — Continued

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Mid-term				
AFR	4.09%	4.05%	4.03%	4.02%
110% AFR	4.51%	4.46%	4.44%	4.42%
120% AFR	4.92%	4.86%	4.83%	4.81%
130% AFR	5.34%	5.27%	5.24%	5.21%
150% AFR	6.17%	6.08%	6.03%	6.00%
175% AFR	7.22%	7.09%	7.03%	6.99%
Long-term				
AFR	4.68%	4.63%	4.60%	4.59%
110% AFR	5.15%	5.09%	5.06%	5.04%
120% AFR	5.64%	5.56%	5.52%	5.50%
130% AFR	6.11%	6.02%	5.98%	5.95%

REV. RUL. 2005–23 TABLE 2

Adjusted AFR for April 2005

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.40%	2.39%	2.38%	2.38%
Mid-term adjusted AFR	3.03%	3.01%	3.00%	2.99%
Long-term adjusted AFR	4.19%	4.15%	4.13%	4.11%

REV. RUL. 2005–23 TABLE 3

Rates Under Section 382 for April 2005

Adjusted federal long-term rate for the current month	4.19%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.20%

REV. RUL. 2005–23 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for April 2005

Appropriate percentage for the 70% present value low-income housing credit	8.02%
Appropriate percentage for the 30% present value low-income housing credit	3.44%

REV. RUL. 2005–23 TABLE 5

Rate Under Section 7520 for April 2005

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.00%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 1502.—Regulations

26 CFR 1.1502–11: Consolidated taxable income.

T.D. 9192

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations, temporary regulations, and removal of temporary regulations.

SUMMARY: This document contains final regulations under section 1502 of the Internal Revenue Code that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. These final regulations affect corporations filing consolidated returns.

DATES: *Effective Date*: These regulations are effective March 21, 2005.

Applicability Dates:: For dates of applicability, see §1.1502–11(c)(7), §1.1502–13(g)(3)(i)(A) and (ii)(C), §1.1502–19(h)(2)(ii), §1.1502–21(h)(6), §1.1502–28(d), and §1.1502–32(h)(7).

FOR FURTHER INFORMATION CONTACT: Concerning §1.1502–11 of the final regulations, Candace B. Ewell at (202) 622–7530 (not a toll-free number), concerning all other sections of the final regulations, Amber R. Cook at (202) 622–7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains amendments to 26 CFR part 1 under section 1502 of the Internal Revenue Code (Code). On September 4, 2003, temporary regulations (T.D. 9089, 2003–2 C.B. 906) (the first temporary regulations) relating to the application of section 108 to members of a consolidated group were published in the **Federal Register** (68 FR 52487). A notice of proposed rulemaking (REG–132760–03, 2003–2 C.B. 933) cross-referencing the first temporary regulations was published in the **Federal Register** for the same day (68 FR 52542). The first temporary regulations added §1.1502–28T, which provides guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income (excluded COD income) and the method for reducing those attributes. Section 1.1502–28T reflects a consolidated approach that is intended to reduce all attributes that are available to the debtor member.

Because the first temporary regulations may not have provided for the reduction of all the attributes that are available to the debtor member, on December 11, 2003, the IRS and Treasury Department published in the **Federal Register** (68 FR 69024) temporary regulations (T.D. 9098, 2003–2 C.B. 1248) (the second temporary regulations) under section 1502 amending §1.1502–28T. A notice of proposed rulemaking (REG–153319–03, 2003–2 C.B. 1256) cross-referencing the second temporary regulations was published in the **Federal Register** for the same day (68 FR 69062). The second temporary regulations clarify that certain attributes that arise (or are treated as arising) in a separate return year are subject to reduction when no SRLY limitation applies to the use of such attributes.

On March 15, 2004, the IRS and Treasury Department published in the **Federal Register** (69 FR 12069) temporary regulations (T.D. 9117, 2004–15 I.R.B. 721) (the third temporary regulations) under section 1502 amending §§1.1502–13 and 1.1502–28T. A notice of proposed rulemaking (REG–167265–03, 2004–15 I.R.B. 730) (the 2004 proposed regulations) cross-referencing the third temporary regulations was published in the **Federal Register** for the same day (69 FR 12091). The third temporary regulations address certain technical issues relating to the application of excluded COD income to reduce attributes under sections 108 and 1017 and §1.1502–28T.

The 2004 proposed regulations, in addition to cross-referencing the third temporary regulations, proposed amendments to §§1.1502–28T and 1.1502–11 to provide a methodology for computing consolidated taxable income and for effecting attribute reduction when there is a disposition of the stock of a member in a year during which any member realizes excluded COD income.

No public hearing was requested or held for any of the regulations described above. Written and electronic comments responding to the notices of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision, and the affected provisions in the

corresponding temporary regulations are removed. The more significant revisions are discussed below.

A. *Apportionment of Net Operating Losses*

In addition to adding §1.1502–28T, the first temporary regulations added several provisions to §1.1502–21T. Sections 1.1502–21 and 1.1502–21T include rules relating to the amount of consolidated net operating losses apportioned to a subsidiary when a subsidiary departs from the group. The provisions added to §1.1502–21T require a recomputation of the percentage of a consolidated net operating loss attributable to a member when a portion of the loss is carried back to a separate return year or is reduced in respect of excluded COD income, or when a member departs. Questions have arisen regarding the timing of the recomputation of the percentage of a consolidated net operating loss attributable to a member in cases in which a portion of a consolidated net operating loss is carried back to a separate return year or a portion is reduced in respect of excluded COD income. Therefore, these final regulations clarify the timing of the recomputation in these cases.

B. *Timing of Asset Basis Reduction*

Section 108(b)(4)(A) requires the reduction of the tax attributes listed in section 108(b)(2), including basis in property, in respect of excluded COD income after the determination of the tax imposed for the taxable year of the discharge. Section 1017(a) provides that when any portion of excluded COD income is to be applied to reduce basis, then such portion is applied to reduce the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. As a result of the reference in section 1017(a) to the property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs, questions have arisen regarding the appropriate time to reduce the basis of property of the taxpayer.

The IRS and Treasury Department believe that the reference in section 1017 to the property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs merely identifies those properties the basis of which are subject to reduction. It does not prescribe that basis of property should not be reduced until the beginning of the taxable year following the taxable year in which the discharge occurs. Accordingly, these regulations clarify that basis of property is subject to reduction pursuant to the rules of sections 108 and 1017 and §1.1502–28 after the determination of tax for the year during which the member realizes excluded COD income (and any prior years) and coincident with the reduction of other attributes pursuant to section 108 and §1.1502–28. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is available for reduction.

C. *Application of Look-Through Rule*

The first temporary regulations include a look-through rule that applies if the attribute of the debtor member reduced is the basis of stock of another member of the group. In these cases, corresponding reductions must be made to the attributes attributable to the lower-tier member. To effect those corresponding reductions, the lower-tier member is treated as realizing excluded COD income in the amount of the stock basis reduction. Questions have arisen regarding whether the look-through rule applies when there is a reduction in the basis of stock of a corporation that is a member of the group on the last day of the debtor's taxable year during which the excluded COD income is realized, but is not a member of the group on the first day of the debtor's following taxable year. For example, suppose P1 owns all of the stock of S1 and S1 owns all of the stock of S2. P1, S1, and S2 file a consolidated return. In Year 1, P1 realizes excluded COD income. On the last day of Year 1, P1 sells 50 percent of the stock of S1 to P2. P1 reduces its basis in the 50 percent of the S1 stock that it owns on the first day of Year 2 in respect of its excluded COD income. Commentators have questioned whether the look-through rule applies to reduce S1's attributes.

The IRS and Treasury Department believe that because S1 and S2 were members of the same group on the last day of the debtor's taxable year during which the excluded COD income was realized, it is appropriate to apply the single entity principles reflected in the look-through rule. The IRS and Treasury Department have also considered whether the look-through rule applies when there is a reduction in the basis of stock of a corporation that is not a member of the group on the last day of the debtor's taxable year during which the excluded COD income is realized (by reason of the application of the next day rule of §1.1502–76), but is a member of the group on the first day of the debtor's following taxable year. In these cases too, the IRS and Treasury Department believe that it is appropriate to apply the single entity principles reflected in the look-through rule. Therefore, these regulations provide that, if the basis of stock of a corporation (the lower-tier member) that is owned by another corporation (the higher-tier member) is reduced and both of such corporations are members of the same consolidated group on the last day of the higher-tier member's taxable year that includes the date on which the excluded COD income is realized or the first day of the higher-tier member's taxable year that follows the taxable year that includes the date on which the excluded COD income is realized, the look-through rule will apply to reduce the attributes of the lower-tier member.

D. *Attributes Available for Reduction on Departure of Debtor Member*

Questions have arisen regarding the identification of the attributes available for reduction in cases in which the member that realizes the excluded COD income leaves the group (for example, by reason of a stock acquisition) or the assets of the member are acquired by a corporation that is not a member of the group in a transaction to which section 381(a) applies on or prior to the last day of the consolidated return year during which the excluded COD income is realized. At least one commentator has questioned whether the attributes of other members of the group from which the debtor member departs are available for reduction in these cases. These final regulations confirm that, in such cases, the tax attributes that remain after the determination of the tax imposed on the group that belong to members of the group are available for reduction.

E. *Intragroup Reorganizations and Group Structure Changes*

Questions have also arisen regarding the application of the attribute reduction rules when a taxpayer that is a member of a consolidated group realizes excluded COD income during the same consolidated return year during which it transfers assets in a transaction to which section 381(a) applies to a corporation that is a member of the group immediately after the transaction. Section 1.108–7 provides that if a taxpayer realizes excluded COD income either during or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in section 381(a), any tax attributes to which the acquiring corporation succeeds, including the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by section 108(b). If a member of the group transfers assets in a transaction to which section 381(a) applies to a corporation that is a member of the group immediately after the transaction and, as a result, the taxable year of the transferor member ends prior to the end of the consolidated return year, the basis of the transferred property following the transfer may generate depreciation deductions that are allowed in computing the group's consolidated taxable income for the entire consolidated return year that includes the date of the discharge. Requiring the basis of the transferred property to reflect a reduction in respect of the excluded COD income immediately after the transfer could arguably violate the directive of section 108(b)(4)(A) that attributes (including basis) be reduced only after the determination of tax for the taxable year of the discharge. However, if attributes were reduced after the determination of the group's tax for the taxable year of the discharge, it may be difficult to determine which attributes of the combined entity are attributable to the debtor member and available for reduction. For example, if after the transaction to which section 381(a) applies the acquiring corporation purchases property, it may be difficult to determine whether that property is property of the debtor the basis of which is available for reduction or property of the acquiring corporation the basis of which may not be available for reduction. Similar issues may arise with respect to other attributes of the transferor.

To address this issue, these final regulations provide that, if the taxable year of a member during which such member realizes excluded COD income ends prior to the last day of the consolidated return year and, on the first day of the taxable year of such member that follows the taxable year during which such member realizes excluded COD income, such member has a successor member, the successor member is treated as if it had realized the excluded COD income. Accordingly, all attributes of the successor member listed in section 108(b)(2) (including attributes that were attributable to the successor member prior to the date such member became a successor member) are subject to reduction prior to the attributes attributable to other members of the group. For this purpose, a successor member means a person to which the member that realizes excluded COD income transfers its assets in a transaction to which section 381(a) applies if such transferee is a member of the group immediately after the transaction. This rule avoids the difficulty of tracing attributes and property of the debtor member once the debtor member has been acquired by another member and recognizes that the direction of a transaction to which section 381(a) applies in a group may not be meaningful. These regulations provide a similar rule for cases in which a member of the group acquires the assets of another member in a transaction to which section 381(a) applies that is also a group structure change.

F. *Application of Next Day Rule*

Under §1.1502–76, a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. A corporation that leaves a consolidated group during the tax year must generally file a short period separate return (or join in the consolidated return of another group) for the portion of the year not included in the consolidated return. If a corporation ceases to be a member during a consolidated return year, it ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends at the end of that day. Under the next day rule, however, any transaction that occurs on the day the member ceases to be affiliated with the group that is properly allocable to the portion of the subsidiary's day after the event terminating affiliation must be treated as occurring at the beginning of the following day. Commentators have questioned whether the next day rule can be applied when the debt of a subsidiary is discharged in exchange for stock of the subsidiary and, as a result of the issuance of the subsidiary's stock to the creditor, the subsidiary ceases to be a member of the group. As a result of the application of that rule, the excluded COD income would be treated as realized at the beginning of the day following the day the subsidiary ceases to be a member of the group, rather than on the day it ceases to be a member of the group.

The IRS and Treasury Department believe that because the excluded COD income accrued in the group, it is not appropriate to apply the next day rule in these cases. Therefore, these regulations provide that the next day rule cannot be applied to treat excluded COD income as realized at the beginning of the day following the day on which it is realized.

G. *Timing of Investment Adjustments*

Under §1.1502–32, excluded COD income of a subsidiary results in a positive basis adjustment to the extent it is applied to reduce attributes and the reduction of the subsidiary's attributes (other than credits) in respect of excluded COD income will generally result in a negative basis adjustment. Commentators have requested clarification regarding when these basis adjustments are effective in cases in which a subsidiary ceases to be a member of the group on or prior to the end of the consolidated return year during which a member realizes excluded COD income. Therefore, these regulations clarify that, in those cases, basis adjustments resulting from the realization of excluded COD income and from the reduction of attributes in respect thereof are made immediately after the determination of tax for the group for the consolidated return year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the day following the day the member departs from the

group. Therefore, if the departing member becomes a member of another group (the new group), the adjustments to the basis of the departing member's stock in respect of the excluded COD income will not cause stock basis adjustments in the new group.

H. *Elimination of Circular Stock Basis on Disposition of Member Stock*

The 2004 proposed regulations provide a methodology for computing consolidated taxable income and for effecting attribute reduction when there is a disposition of member stock during the same taxable year in which any member realizes excluded COD income. The methodology is intended to prevent the reduction of tax attributes from affecting the basis of the member stock that is sold, which would affect the tax liability of the group for the taxable year of the discharge. Accordingly, the methodology limits the actual reduction of tax attributes to the amount of tax attributes available for reduction following the tentative computation of taxable income (or loss).

Commentators have noted, however, that pursuant to section 108(b)(4)(A), attributes are reduced only after the determination of tax for the taxable year of the discharge. Computing the limitation on attribute reduction based on the tax attributes remaining after a tentative computation of taxable income (or loss) does not account for the use of credits in the computation of the group's tax liability for the taxable year of the discharge. Therefore, in response to these comments, the final regulations provide for the computation of the limitation on attribute reduction after the computation of the tax imposed by chapter 1 of the Code, rather than after the computation of taxable income (or loss).

I. *Transactions Designed to Avoid the Application of the Attribute Reduction Rules*

The preamble to the first temporary regulations stated that the IRS and Treasury Department are considering adopting rules under section 1502 (and possibly other Code sections) to address the effect of transitory transactions and other transactions designed to avoid the application of the rules concerning attribute reduction. The IRS and Treasury Department continue to believe that general principles (including step transaction doctrine) could be applied to disregard certain transactions that have the effect of changing the result of the application of the attribute reduction rules. Therefore, the IRS and Treasury Department have decided not to adopt any additional rules at this time.

J. *Elective Retroactive Application of Final Regulation*

The portion of these regulations finalizing the rules contained in §1.1502–28T apply to discharges of indebtedness that occur after March 21, 2005. Groups, however, may apply those rules in whole, but not in part, to discharges of indebtedness that occur on or before March 21, 2005, and after August 29, 2003.

These regulations also permit further retroactive application of a rule included in the third temporary regulations that prevents the potential duplication of ordinary income recapture under section 1245 that could be caused by reason of the application of both section 1245 and either section 1017(b)(3)(D) (which permits subsidiary stock to be treated as depreciable property to the extent that the subsidiary consents to a corresponding reduction in the basis of its depreciable property) or the look-through rule. This section 1245 rule provides that a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of the look-through rule. The third temporary regulations made this special rule effective for discharges of indebtedness that occur after August 29, 2003, the effective date of the look-through rule. The IRS and Treasury Department are aware that the problem addressed by this special rule could have occurred in cases of discharges of indebtedness that occurred before August 29, 2003, if section 1017(b)(3)(D) was applied. Accordingly, these final regulations provide that groups may apply this special rule to discharges of indebtedness that occur on or before August 29, 2003, in cases in which section 1017(b)(3)(D) was applied.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Further, it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file a consolidated return, which tend to be larger businesses. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Amber R. Cook of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§1.1502–13T, 1.1502–19T, and 1.1502–28T and adding the following entry in numerical order to read, in part, as follows:

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

Section 1.1502–28 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–11 is amended as follows:

1. Paragraph (b)(1) is revised.

2. Paragraph (c) is redesignated as paragraph (d).

3. New paragraph (c) is added.

The revision and addition read as follows:

§1.1502–11 Consolidated taxable income.

* * * * *

(b) *Elimination of circular stock basis adjustments when there is no excluded COD income*—(1) *In general*. If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increased absorption would reduce P's basis (or increase its excess loss account) in S's stock under §1.1502–32 and, in turn, increase P's income or gain. See paragraph (b)(3) of this section for the application of these principles to P's deduction or loss from the disposition of S's stock, and paragraph (b)(4) of this section for the application of these principles to multiple stock dispositions. This paragraph (b) applies only when no member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) (excluded COD income) during the taxable year of the disposition. See paragraph (c) of this section for rules that apply when a member realizes excluded COD income during the taxable year of the disposition. See §1.1502–19(c) for the definition of disposition.

* * * * *

(c) *Elimination of circular stock basis adjustments when there is excluded COD income*—(1) *In general*. If one member (P) disposes of the stock of another member (S) in a year during which any member realizes excluded COD income, this paragraph (c) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years, the amount of the attributes of certain members that can be reduced in respect of excluded COD income of certain other members, and the attributes that can be used to offset an excess loss account taken into account by reason of the application of §1.1502–19(c)(1)(iii)(B). In addition to the purpose set forth in paragraph (b)(1) of this section, the purpose of these limitations is to prevent the reduction of tax attributes in respect of excluded COD income from affecting P's income, gain, or loss on the disposition of S stock (including a disposition of S stock that results from the application of §1.1502–19(c)(1)(iii)(B)) and, in turn, affecting the attributes available for reduction pursuant to sections 108 and 1017 and §1.1502–28. See §1.1502–19(c) for the definition of disposition.

(2) *Computation of tax liability, reduction of attributes, and computation of limits on absorption and reduction of attributes*. If a member realizes excluded COD income in the taxable year during which P disposes of S stock, the steps used to compute tax liability, to effect the reduction of attributes, and to compute the limitations on the absorption and reduction of attributes are as follows. These steps also apply to determine whether and to what extent an excess loss account must be taken into account as a result of the application of §1.1502–19(b)(1) and (c)(1)(iii)(B).

(i) *Limitation on deductions and losses to offset income or gain*. First, the determination of the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior years) may offset income and gain is made pursuant to paragraphs (b)(2) and (3) of this section.

(ii) *Tentative adjustment of stock basis*. Second, §1.1502–32 is tentatively applied to adjust the basis of the S stock to reflect the amount of S's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of taxable income or loss for the year of the disposition (and any prior years) that is made pursuant to paragraph (b)(2) of this section, but not to reflect the realization of excluded COD income and the reduction of attributes in respect thereof.

(iii) *Tentative computation of stock gain or loss*. Third, in the case of a disposition of S stock that does not result from the application of §1.1502–19(c)(1)(iii)(B), P's income, gain, or loss from the disposition of S stock is computed. For this purpose, the result of the computation pursuant to paragraph (c)(2)(ii) of this section is treated as the basis of such stock.

(iv) *Tentative computation of tax imposed*. Fourth, the tax imposed by chapter 1 of the Internal Revenue Code for the year of disposition (and any prior years) is tentatively computed. For this purpose, in the case of a disposition of S stock that does not result from the application of §1.1502–19(c)(1)(iii)(B), the tentative computation of tax imposed takes into account P's income, gain, or loss from the disposition of S stock computed pursuant to paragraph (c)(2)(iii) of this section. The tentative computation of tax imposed is made without regard to whether all or a portion of an excess loss account in a share of S stock is required to be taken into account pursuant to §1.1502–19(b)(1) and (c)(1)(iii)(B).

(v) *Tentative reduction of attributes*. Fifth, the rules of sections 108 and 1017 and §1.1502–28 are tentatively applied to reduce the attributes remaining after the tentative computation of tax imposed pursuant to paragraph (c)(2)(iv) of this section.

(vi) *Actual adjustment of stock basis*. Sixth, §1.1502–32 is applied to reflect the amount of S's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of tax imposed for the year of the disposition (and any prior years) made pursuant to paragraph (c)(2)(iv) of this section, and the excluded COD income applied to reduce attributes and the attributes tentatively reduced in respect of the excluded COD income pursuant to paragraph (c)(2)(v) of this section.

(vii) *Actual computation of stock gain or loss*. Seventh, the group's actual gain or loss on the disposition of S stock (including a disposition that results from the application of §1.1502–19(c)(1)(iii)(B)) is computed. The result of the computation pursuant to paragraph (c)(2)(vi) of this section is treated as the basis of such stock.

(viii) *Actual computation of tax imposed*. Eighth, the tax imposed by chapter 1 of the Internal Revenue Code for the year of the disposition (and any prior years) is computed. The actual tax imposed on the group for the year of the disposition is computed by applying the limitation computed pursuant to paragraph (c)(2)(i) of this section, and by including the gain or loss recognized on the disposition of S stock computed pursuant to paragraph (c)(2)(vii) of this section. However, attributes that were tentatively used in the computation of tax imposed pursuant to paragraph (c)(2)(iv) of this section and attributes that were tentatively reduced

pursuant to paragraph (c)(2)(v) of this section cannot offset any excess loss account taken into account as a result of the application of §1.1502–19(b)(1) and (c)(1)(iii)(B).

(ix) *Actual reduction of attributes*. Ninth, the rules of sections 108 and 1017 and §1.1502–28 are actually applied to reduce the attributes remaining after the actual computation of tax imposed pursuant to paragraph (c)(2)(viii) of this section.

(A) *S or a lower-tier corporation realizes excluded COD income*. If S or a lower-tier corporation of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to this paragraph (c)(2)(ix) shall not exceed the aggregate amount of excluded COD income that was tentatively applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to paragraph (c)(2)(v) of this section. The amount of the actual reduction of attributes attributable to S and any lower-tier corporation of S that may be reduced in respect of the excluded COD income of S or a lower-tier corporation of S shall not be so limited.

(B) *A member other than S or a lower-tier corporation realizes excluded COD income*. If a member other than S or a lower-tier corporation of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S pursuant to this paragraph (c)(2)(ix) shall not exceed the aggregate amount of excluded COD income that was tentatively applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S pursuant to paragraph (c)(2)(v) of this section. The amount of the actual reduction of attributes attributable to any member other than S and any lower-tier corporation of S that may be reduced in respect of the excluded COD income of S or a lower-tier corporation of S shall not be so limited.

(3) *Special rules*. (i) If the reduction of attributes attributable to a member is prevented as a result of a limitation described in paragraph (c)(2)(ix)(B) of this section, the excluded COD income that would have otherwise been applied to reduce such attributes is applied to reduce the remaining attributes of the same type that are available for reduction under §1.1502–28(a)(4), on a *pro rata* basis, prior to reducing attributes of a different type. The reduction of such remaining attributes, however, is subject to any applicable limitation described in paragraph (c)(2)(ix)(B) of this section.

(ii) To the extent S's deductions and losses in the year of disposition (or those of a lower-tier corporation of S) cannot offset income or gain because of the limitation under paragraph (b) of this section or this paragraph (c) and are not reduced pursuant to sections 108 and 1017 and §1.1502–28, such items are carried to other years under the applicable provisions of the Internal Revenue Code and regulations as if they were the only items incurred by S (or a lower-tier corporation of S) in the year of disposition. For example, to the extent S incurs an operating loss in the year of disposition that is limited and is not reduced pursuant to section 108 and §1.1502–28, the loss is treated as a separate net operating loss attributable to S arising in that year.

(4) *Definition of lower-tier corporation*. A corporation is a lower-tier corporation of S if all of its items of income, gain, deduction, and loss (including the absorption of deduction or loss and the reduction of attributes other than credits) would be fully reflected in P's basis in S's stock under §1.1502–32.

(5) *Examples*. For purposes of the examples in this paragraph (c), unless otherwise stated, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, tax liabilities are disregarded, and no election under section 108(b)(5) is made. The principles of this paragraph (c) are illustrated by the following examples:

Example 1. Departing member realizes excluded COD income. (i) *Facts*. P owns all of S's stock with a $90 basis. For Year 1, P has ordinary income of $30, and S has an $80 ordinary loss and $100 of excluded COD income from the discharge of non-intercompany indebtedness. P sells the S stock for $20 at the close of Year 1. As of the beginning of Year 2, S has Asset A with a basis of $0 and a fair market value of $20.

(ii) *Analysis*. The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain*. To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S's loss and the effect of the absorption of S's loss on P's basis in S's stock under §1.1502–32(b), P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus S's $80 loss). Thus, $30 of S's loss is unlimited and $50 of S's loss is limited under paragraph (c)(2)(i) of this section. Under the principles of §1.1502–21(b)(2)(iv), all of the consolidated net operating loss is attributable to S.

(B) *Tentative adjustment of stock basis*. Then, pursuant to paragraph (c)(2)(ii) of this section, §1.1502–32 is tentatively applied to adjust the basis of S stock. For this purpose, however, adjustments attributable to the excluded COD income and the reduction of attributes in respect thereof are not taken into account. Under §1.1502–32(b), the absorption of $30 of S's loss decreases P's basis in S's stock by $30 to $60.

(C) *Tentative computation of stock gain or loss*. Then, P's income, gain, or loss from the sale of S stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a $40 loss from the sale of S stock.

(D) *Tentative computation of tax imposed*. Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for the year of disposition is then tentatively computed, taking into account P's $40 loss on the sale of the S stock computed pursuant to paragraph (c)(2)(iii) of this section. The group has a $50 consolidated net operating loss for Year 1 that, under the principles of §1.1502–21(b)(2)(iv), is wholly attributable to S and a consolidated capital loss of $40 that, under the principles of §1.1502–21(b)(2)(iv), is wholly attributable to P.

(E) *Tentative reduction of attributes*. Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28 are tentatively applied to reduce attributes remaining after the tentative computation of the tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S would first be reduced to take into account its $100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 would be reduced by $50, the portion of that consolidated net operating loss attributable to S under the principles of §1.1502–21(b)(2)(iv), to $0. Then, pursuant to §1.1502–28(a)(4), S's remaining $50 of excluded COD income would reduce the consolidated capital loss attributable to P of $40 by $40 to $0. The remaining $10 of excluded COD income would have no effect.

(F) *Actual adjustment of stock basis*. Pursuant to paragraph (c)(2)(vi) of this section, §1.1502–32 is applied to reflect the amount of S's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of the tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32(b), the absorption of $30 of S's loss, the application of $90 of S's excluded COD income to reduce attributes of P and S, and the reduction of the

$50 loss attributable to S in respect of the excluded COD income results in a positive adjustment of $10 to P's basis in the S stock. P's basis in the S stock, therefore, is $100.

(G) *Actual computation of stock gain or loss*. Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S stock is computed using the basis computed in the previous step. Accordingly, P recognizes an $80 loss on the disposition of the S stock.

(H) *Actual computation of tax imposed*. Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account P's $80 loss from the sale of S stock. Before the application of §1.1502–28, therefore, the group has a consolidated net operating loss of $50 that is wholly attributable to S under the principles of §1.1502–21(b)(2)(iv), and a consolidated capital loss of $80 that is wholly attributable to P under the principles of §1.1502–21(b)(2)(iv).

(I) *Actual reduction of attributes*. Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S must first be reduced to take into account its $100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 is reduced by $50, the portion of that consolidated net operating loss attributable to S under the principles of §1.1502–21(b)(2)(iv), to $0. Then, pursuant to §1.1502–28(a)(4), S's remaining $50 of excluded COD income reduces consolidated tax attributes. In particular, without regard to the limitation imposed by paragraph (c)(2)(ix)(A) of this section, the $80 consolidated capital loss, which under the principles of §1.1502–21(b)(2)(iv) is attributable to P, would be reduced by $50 from $80 to $30. However, the limitation imposed by paragraph (c)(2)(ix)(A) of this section prevents the reduction of the consolidated capital loss attributable to P by more than $40. Therefore, the consolidated capital loss attributable to P is reduced by only $40 in respect of S's excluded COD income. The remaining $10 of excluded COD income has no effect.

Example 2. Member other than departing member realizes excluded COD income. (i) *Facts*. P owns all of S1's and S2's stock. P's basis in S2's stock is $600. For Year 1, P has ordinary income of $30, S1 has a $100 ordinary loss and $100 of excluded COD income from the discharge of non-intercompany indebtedness, and S2 has $200 of ordinary loss. P sells the S2 stock for $600 at the close of Year 1. As of the beginning of Year 2, S1 has Asset A with a basis of $0 and a fair market value of $10.

(ii) *Analysis*. The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain*. To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S2's loss and the effect of the absorption of S2's loss on P's basis in S2's stock under §1.1502–32(b), P's gain or loss from the sale of S2's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $270 (P's $30 of income minus S1's $100 loss and S2's $200 loss). Consequently, $20 of S2's loss from Year 1 is unlimited and $180 of S2's loss from Year 1 is limited under paragraph (c)(2)(i) of this section. Under the principles of §1.1502–21(b)(2)(iv), $90 of the consolidated net operating loss is attributable to S1 and $180 of the consolidated net operating loss is attributable to S2.

(B) *Tentative adjustment of stock basis*. Then, pursuant to paragraph (c)(2)(ii) of this section, §1.1502–32 is tentatively applied to adjust the basis of S2's stock. For this purpose, however, adjustments to the basis of S2's stock attributable to the reduction of attributes in respect of S1's excluded COD income are not taken into account. Under §1.1502–32(b), the absorption of $20 of S2's loss decreases P's basis in S2's stock by $20 to $580.

(C) *Tentative computation of stock gain or loss*. Then, P's income, gain, or loss from the disposition of S2 stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a $20 gain from the sale of the S2 stock.

(D) *Tentative computation of tax imposed*. Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for the year of disposition is then tentatively computed, taking into account P's $20 gain from the sale of S2 stock computed pursuant to paragraph (c)(2)(iii) of this section. Although S2's limited loss cannot be used to offset P's $20 gain from the sale of S2's stock under the rules of this section, S1's loss will offset that gain. Therefore, the group is tentatively treated as having a consolidated net operating loss of $250, $70 of which is attributable to S1 and $180 of which is attributable to S2 under the principles of §1.1502–21(b)(2)(iv).

(E) *Tentative reduction of attributes*. Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28 are tentatively applied to reduce attributes remaining after the tentative computation of the tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S1 would first be reduced to take into account its $100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 would be reduced by $70, the portion of that consolidated net operating loss attributable to S1 under the principles of §1.1502–21(b)(2)(iv), to $0. Then, pursuant to §1.1502–28(a)(4), S1's remaining $30 of excluded COD income would reduce the consolidated net operating loss for Year 1 attributable to S2 of $180 by $30 to $150.

(F) *Actual adjustment of stock basis*. Pursuant to paragraph (c)(2)(vi) of this section, §1.1502–32 is applied to reflect the amount of S2's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of the tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32(b), the absorption of $20 of S2's loss to offset a portion of P's income and the application of $30 of S1's excluded COD income to reduce attributes attributable to S2 results in a negative adjustment of $50 to P's basis in the S2 stock. P's basis in the S2 stock, therefore, is $550.

(G) *Actual computation of stock gain or loss*. Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S2 stock is computed using the basis computed in the previous step. Therefore, P recognizes a $50 gain on the disposition of the S2 stock.

(H) *Actual computation of tax imposed*. Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account P's $50 gain from the disposition of the S2 stock. Before the application of §1.1502–28, therefore, the group has a consolidated net operating loss of $220, $40 of which is attributable to S1 and $180 of which is attributable to S2 under the principles of §1.1502–21(b)(2)(iv).

(I) *Actual reduction of attributes*. Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S1 must first be reduced to take into account its $100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 is reduced by $40, the portion of that consolidated net operating loss attributable to S1 under the principles of §1.1502–21(b)(2)(iv), to $0. Then, pursuant to §1.1502–28(a)(4), without regard to the limitation imposed by paragraph (c)(2)(ix)(B) of this section, S1's remaining $60 of excluded COD income would reduce S2's net operating loss of $180 to $120. However, the limitation imposed by paragraph (c)(2)(ix)(B) of this section prevents the reduction of S2's loss by more than $30. Therefore, S2's loss of $180 is reduced by $30 to $150 in respect of S1's excluded COD income. The remaining $30 of excluded COD income has no effect.

Example 3. Lower-tier corporation of departing member realizes excluded COD income. (i) *Facts*. P owns all of S1's stock, S2's stock, and S3's stock. S1 owns all of S4's stock. P's basis in S1's stock is $50 and S1's basis in S4's stock is $50. For Year 1, P has $50 of ordinary loss, S1 has $100 of ordinary loss, S2 has $150 of ordinary loss, S3 has $50 of ordinary loss, and S4 has $50 of ordinary loss and $80 of excluded COD income from the discharge of non-intercompany indebtedness. P sells the S1 stock for $100 at the close of Year 1. As of the beginning of Year 2, S4 has Asset A with a fair market value of $10. After the computation of tax imposed for Year 1 and before the application of sections 108 and 1017 and §1.1502–28, Asset A has a basis of $0.

(ii) *Analysis*. The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain*. To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S1's and S4's losses and the effect of the absorption of S1's and S4's losses on P's basis in S1's stock under §1.1502–32(b), P's gain or loss from the sale of S1's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $400. Consequently, $100 of S1's loss and $50 of S4's loss is limited under paragraph (c)(2)(i) of this section.

(B) *Tentative adjustment of stock basis*. Then, pursuant to paragraph (c)(2)(ii) of this section, §1.1502–32 is tentatively applied to adjust the basis of S1's stock. For this purpose, adjustments to the basis of S1's stock attributable to S4's realization of excluded COD income and the reduction of at-

tributes in respect of such excluded COD income are not taken into account. There is no adjustment under §1.1502–32 to the basis of the S1 stock. Therefore, P's basis in the S1 stock for this purpose is $50.

(C) *Tentative computation of stock gain or loss.* Then, P's income, gain, or loss from the sale of S1 stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a $50 gain from the sale of the S1 stock.

(D) *Tentative computation of tax imposed.* Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for the year of disposition is then tentatively computed, taking into account P's $50 gain from the sale of the S1 stock computed pursuant to paragraph (c)(2)(iii) of this section. Although S1's and S4's limited losses cannot be used to offset P's $50 gain from the sale of S1's stock under the rules of this section, $10 of P's loss, $30 of S2's loss, and $10 of S3's loss will offset that gain. Therefore, the group is tentatively treated as having a consolidated net operating loss of $350, $40 of which is attributable to P, $100 of which is attributable to S1, $120 of which is attributable to S2, $40 of which is attributable to S3, and $50 of which is attributable to S4 under the principles of §1.1502–21(b)(2)(iv).

(E) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28 are tentatively applied to reduce attributes remaining after the tentative computation of the tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S4 would first be reduced to take into account its $80 of excluded COD. Accordingly, the consolidated net operating loss for Year 1 would be reduced by $50, the portion of the consolidated net operating loss attributable to S4 under the principles of §1.1502–21(b)(2)(iv), to $300. Then, pursuant to §1.1502–28(a)(4), S4's remaining $30 of excluded COD income would reduce the consolidated net operating loss for Year 1 that is attributable to other members. Therefore, the consolidated net operating loss for Year 1 would be reduced by $30. Of that amount, $4 is attributable to P, $10 is attributable to S1, $12 is attributable to S2, and $4 is attributable to S3.

(F) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, §1.1502–32 is applied to reflect the amount of S1's and S4's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32(b), the application of $80 of S4's excluded COD income to reduce attributes, and the reduction of S4's loss in the amount of $50 and S1's loss in the amount of $10 in respect of the excluded COD income results in a positive adjustment of $20 to P's basis in the S1 stock. Accordingly, P's basis in S1 stock is $70.

(G) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S1 stock is computed using the basis computed in the previous step. Accordingly, P recognizes a $30 gain on the disposition of the S1 stock.

(H) *Actual computation of tax imposed.* Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account P's $30 gain from the sale of S1 stock. Before the application of §1.1502–28, therefore, the group has a consolidated net operating loss of $370, $44 of which is attributable to P, $100 of which is attributable to S1, $132 of which is attributable to S2, $44 of which is attributable to S3, and $50 of which is attributable to S4.

(I) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S4 must first be reduced to take into account its $80 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 is reduced by $50, the portion of that consolidated net operating loss attributable to S4 under the principles of §1.1502–21(b)(2)(iv), to $320. Then, pursuant to §1.1502–28(a)(4), without regard to the limitation imposed by paragraph (c)(2)(ix)(A) of this section, S4's remaining $30 of excluded COD income would reduce the consolidated net operating loss for Year 1 by $30 ($4.12 of the consolidated net operating loss attributable to P, $9.38 of the consolidated net operating loss attributable to S1, $12.38 of the consolidated net operating loss attributable to S2, and $4.12 of the consolidated net operating loss attributable to S3) to $290. However, the limitation imposed by paragraph (c)(2)(ix)(A) of this section prevents the reduction of the consolidated net operating loss attributable to P, S2, and S3 by more than $4, $12, and $4 respectively. The $.62 of excluded COD income that would have otherwise reduced the consolidated net operating loss attributable to P, S2, and S3 is applied to reduce the consolidated net operating loss attributable to S1. Therefore, S1 carries forward $90 of loss.

Example 4. Excess loss account taken into account. (i) *Facts.* P is the common parent of a consolidated group. On Day 1 of Year 2, P acquired all of the stock of S1. As of the beginning of Year 2, S1 had a $30 net operating loss carryover from Year 1, a separate return limitation year. A limitation under §1.1502–21(c) applies to the use of that loss by the P group. For Years 1 and 2, the P group had no consolidated taxable income or loss. On Day 1 of Year 3, S1 acquired all of the stock of S2 for $10. In Year 3, P had ordinary income of $10, S1 had ordinary income of $25, and S2 had an ordinary loss of $50. In addition, in Year 3, S2 realized $20 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S2 had no liabilities. As of the beginning of Year 4, S2 had Asset A with a fair market value of $10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and §1.1502–28, Asset A has a basis of $0. S2 had no taxable income (or loss) for Year 1 and Year 2.

(ii) *Analysis.* The steps used to compute the tax imposed on the group, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain, tentative basis adjustments, tentative computation of stock gain or loss.* Because it is not initially apparent that there has been a disposition of stock, paragraph (c)(2)(i) of this section does not limit the use of deductions to offset income or gain, no adjustments to the basis are required pursuant to paragraph (c)(2)(ii) of this section, and no stock gain or loss is computed pursuant to paragraph (c)(2)(iii) of this section or taken into account in the tentative computation of tax imposed pursuant to paragraph (c)(2)(iv) of this section.

(B) *Tentative computation of tax imposed.* Pursuant to paragraph (c)(2)(iv) of this section, the tax imposed for Year 3 is tentatively computed. For Year 3, the P group has a consolidated taxable loss of $15, all of which is attributable to S2 under the principles of §1.1502–21(b)(2)(iv).

(C) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28 are tentatively applied to reduce attributes remaining after the tentative computation of tax imposed. Pursuant to §1.1502–28(a)(2), the tax attributes attributable to S2 would first be reduced to take into account its $20 of excluded COD income. Accordingly, the consolidated net operating loss for Year 3 is reduced by $15, the portion of that consolidated net operating loss attributable to S2 under the principles of §1.1502–21(b)(2)(iv), to $0. The remaining $5 of excluded COD income is not applied to reduce attributes as there are no remaining attributes that are subject to reduction.

(D) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, §1.1502–32 is applied to reflect the amount of S2's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation of tax imposed for the year of the disposition and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32, the absorption of $35 of S2's loss, the application of $15 in respect of S2's excluded COD income to reduce attributes, and the reduction of $15 in respect of the loss attributable to S2 reduced in respect of the excluded COD income results in a negative adjustment of $35 to the basis of the S2 stock. Therefore, S1 has an excess loss account of $25 in the S2 stock.

(E) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, S1's actual gain or loss, if any, on the S2 stock is computed. Because S2 realized $5 of excluded COD income that was not applied to reduce attributes, pursuant to §1.1502–19(b)(1) and (c)(1)(iii)(B), S1 is required to take into account $5 of its excess loss account in the S2 stock.

(F) *Actual computation of tax imposed.* Pursuant to paragraph (c)(2)(viii) of this section, the tax imposed is computed by taking into account the $5 of the excess loss account in the S2 stock required to be taken into account. See §1.1502–28(b)(6) (requiring an excess loss account that is required to be taken into account as a result of the application of §1.1502–19(c)(1)(iii)(B) to be included in the group's tax return for the year that includes the date of the debt discharge). However, pursuant to paragraph (c)(2)(viii) of this section, such amount may not be offset by any of the consolidated net operating loss attributable to S2. It may, however, subject to applicable limitations, be offset by the separate net operating loss of S1 from Year 1.

(G) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and

1017 and §1.1502–28 are then actually applied to reduce attributes remaining after the actual computation of the tax imposed. Attributes will be actually reduced in the same way that they were tentatively reduced.

(6) *Additional rules for multiple dispositions*. [Reserved].

(7) *Effective date*. This paragraph (c) applies to dispositions of subsidiary stock that occur after March 22, 2005. Taxpayers may apply §1.1502–11(c) of REG–167265–03, 2004–15 I.R.B. 730 (see §601.601(d)(2) of this chapter) in whole, but not in part, to any disposition of subsidiary stock that occurs on or before March 22, 2005, if a member of the group realized excluded COD income after August 29, 2003, in the taxable year that includes the date of the disposition of such subsidiary stock.

* * * * *

Par. 3. Section 1.1502–13 is amended as follows:

1. Three sentences are added at the end of paragraph (g)(3)(i)(A).

2. Paragraph (g)(3)(ii)(B) is revised.

3. Paragraph (g)(3)(ii)(C) is added.

The revision and additions read as follows:

§1.1502–13 Intercompany transactions.

* * * * *

(g) * * *

(3) * * *

(i) * * *

(A) * * * For purposes of the preceding sentence, a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and 1.1502–28 is not a comparable transaction. Notwithstanding paragraph (l) of this section, the preceding sentence applies to transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) after March 21, 2005. For transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) on or before March 21, 2005, and after March 12, 2004, see §1.1502–13T(g)(3)(ii)(B)(*3*) as contained in 26 CFR part 1 revised as of April 1, 2004.

* * * * *

(ii) * * *

(B) *Timing and attributes*. For purposes of applying the matching rule and the acceleration rule —

(*1*) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from being excluded from gross income;

(*2*) Paragraph (c)(6)(i) of this section (treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and §1.1502–28; and

(*3*) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091.

(C) *Effective date*. Notwithstanding paragraph (l) of this section, paragraph (g)(3)(ii)(B) of this section applies to transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) after March 12, 2004. For transactions or events occurring during a taxable year the original return for which is due (without regard to extensions) on or before March 12, 2004, see §1.1502–13(g)(3)(ii)(B) as contained in 26 CFR part 1 revised as of April 1, 2003.

* * * * *

§1.1502–13T [Removed]

Par. 4. Section 1.1502–13T is removed.

Par. 5. Section 1.1502–19 is amended as follows:

1. Paragraph (b)(1) is revised.

2. Paragraph (h)(2)(ii) is revised.

The revisions read as follows:

§1.1502–19 Excess loss accounts.

* * * * *

(b) * * *

(1) *Operating rules*—(i) *General rule*. Except as provided in paragraph (b)(1)(ii) of this section, if P is treated under this section as disposing of a share of S's stock, P takes into account its excess loss account in the share as income or gain from the disposition.

(ii) *Special limitation on amount taken into account*. Notwithstanding paragraph (b)(1)(i) of this section, if P is treated as disposing of a share of S's stock as a result of the application of paragraph (c)(1)(iii)(B) of this section, the aggregate amount of its excess loss account in the shares of S's stock that P takes into account as income or gain from the disposition shall not exceed the amount of S's indebtedness that is discharged that is neither included in gross income nor treated as tax-exempt income under §1.1502–32(b)(3)(ii)(C)(*1*). If more than one share of S's stock has an excess loss account, such excess loss accounts shall be taken into account pursuant to the preceding sentence, to the extent possible, in a manner that equalizes the excess loss accounts in S's shares that have an excess loss account.

(iii) *Treatment of disposition.* Except as provided in paragraph (b)(4) of this section, the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.

* * * * *

(h) * * *

(2) * * *

(ii) *Application of special limitation*. If P was treated as disposing of stock of S because S was treated as worthless as a result of the application of paragraph (c)(1)(iii)(B) of this section after August 29, 2003, the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount, are determined or redetermined with regard to paragraph (b)(1)(ii) of this section. If P was treated as disposing of stock of S because S was treated as worthless as a result of the application of paragraph (c)(1)(iii)(B) of this section on or before August 29, 2003, the group may determine or redetermine the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount with regard to paragraph (b)(1)(ii) of this section.

* * * * *

§1.1502–19T [Removed]

Par. 6. Section 1.1502–19T is removed.

Par. 7. In §1.1502–21, paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), (c)(2)(vii), and (h)(6) are revised to read as follows:

§1.1502–21 Net operating losses.

* * * * *

(b) * * *

(1) *Carryovers and carrybacks generally.* The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a *pro rata* basis. In addition, the amount of any CNOL absorbed by the group in any year is apportioned among members based on the percentage of the CNOL attributable to each member as of the beginning of the year. The percentage of the CNOL attributable to a member is determined pursuant to paragraph (b)(2)(iv)(B) of this section. Additional rules provided under the Internal Revenue Code or regulations also apply. See, *e.g.*, section 382(l)(2)(B) (if losses are carried from the same taxable year, losses subject to limitation under section 382 are absorbed before losses that are not subject to limitation under section 382). See paragraph (c)(1)(iii) of this section, *Example 2*, for an illustration of *pro rata* absorption of losses subject to a SRLY limitation. See §1.1502–21T(b)(3)(v) regarding the treatment of any loss that is treated as expired under §1.1502–35T(f)(1).

(2) * * *

(ii) *Special rules*—(A) *Year of departure from group*. If a corporation ceases to be a member during a consolidated return year, net operating loss carryovers attributable to the corporation are first carried to the consolidated return year, and then are subject to reduction under section 108 and §1.1502–28 in respect of discharge of indebtedness income that is realized by a member of the group and that is excluded from gross income under section 108(a). Only the amount so attributable that is not absorbed by the group in that year or reduced under section 108 and §1.1502–28 is carried to the corporation's first separate return year. For rules concerning a member departing a subgroup, see paragraph (c)(2)(vii) of this section.

* * * * *

(iv) *Operating rules*—(A) *Amount of CNOL attributable to a member*. The amount of a CNOL that is attributable to a member shall equal the product of the CNOL and the percentage of the CNOL attributable to such member.

(B) *Percentage of CNOL attributable to a member*—(*1*) *In general*. Except as provided in paragraph (b)(2)(iv)(B)(*2*) of this section, the percentage of the CNOL attributable to a member shall equal the separate net operating loss of the member for the year of the loss divided by the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

(*2*) *Special rules*—(*i*) *Carryback to a separate return year*. If a portion of the CNOL attributable to a member for a taxable year is carried back to a separate return year, the percentage of the CNOL attributable to each member as of immediately after such portion of the CNOL is carried back shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*iv*) of this section.

(*ii*) *Excluded discharge of indebtedness income*. If during a taxable year a member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) and such amount reduces any portion of the CNOL attributable to any member pursuant to section 108 and §1.1502–28, the percentage of the CNOL attributable to each member as of immediately after the reduction of attributes pursuant to sections 108 and 1017 and §1.1502–28 shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*iv*) of this section.

(*iii*) *Departing member*. If during a taxable year a member that had a separate net operating loss for the year of the CNOL ceases to be a member, the percentage of the CNOL attributable to each member as of the first day of the following consolidated return year shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*iv*) of this section.

(*iv*) *Recomputed percentage*. The recomputed percentage of the CNOL attributable to each member shall equal the unabsorbed CNOL attributable to the member at the time of the recomputation divided by the sum of the unabsorbed CNOL attributable to all of the members at the time of the recomputation. For purposes of the preceding sentence, a CNOL that is reduced pursuant to section 108 and §1.1502–28 or that is otherwise permanently disallowed or eliminated shall be treated as absorbed.

* * * * *

(c) * * *

(2) * * *

(vii) *Corporations that leave a SRLY subgroup*. If a loss member ceases to be affiliated with a SRLY subgroup, the amount of the member's remaining SRLY loss from a specific year is determined pursuant to the principles of paragraphs (b)(2)(ii)(A) and (b)(2)(iv) of this section.

* * * * *

(h) * * *

(6) *Certain prior periods*. Paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), and (c)(2)(vii) of this section shall apply to taxable years the original return for which the due date (without regard to extensions) is after March 21, 2005. Paragraph (b)(2)(ii)(A) of this section and §1.1502–21T(b)(1), (b)(2)(iv), and (c)(2)(vii) as contained in 26 CFR part 1 revised as of April 1, 2004, shall apply to taxable years the original return for which the due date (without regard to extensions) is on or before March 21, 2005, and after August 29, 2003. For taxable years the original return for which the due date (without regard to extensions) is on or before August 29, 2003, see paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), and (c)(2)(vii) of this section and §1.1502–21T(b)(1) as contained in 26 CFR part 1 revised as of April 1, 2003.

* * * * *

Par. 8. Section 1.1502–21T is amended as follows:

1. Paragraphs (a) through (b)(2)(v) are revised.

2. Paragraphs (c)(1) through (h)(7) are revised.

The revisions read as follows:

§1.1502–21T Net operating losses (temporary).

(a) through (b)(2)(v) [Reserved]. For further guidance, see §1.1502–21(a) through (b)(2)(v).

* * * * *

(c)(1) through (h)(7) [Reserved]. For further guidance, see §1.1502–21(c)(1) through (h)(7).

* * * * *

Par. 9. Section 1.1502–28 is added to read as follows:

§1.1502–28 Consolidated section 108.

(a) *In general*. This section sets forth rules for the application of section 108(a) and the reduction of tax attributes pursuant to section 108(b) when a member of the group realizes discharge of indebtedness income that is excluded from gross income under section 108(a) (excluded COD income).

(1) *Application of section 108(a)*. Section 108(a)(1)(A) and (B) is applied separately to each member that realizes excluded COD income. Therefore, the limitation of section 108(a)(3) on the amount of discharge of indebtedness income that is treated as excluded COD income is determined based on the assets (including stock and securities of other members) and liabilities (including liabilities to other members) of only the member that realizes excluded COD income.

(2) *Reduction of tax attributes attributable to the debtor*—(i) *In general*. With respect to a member that realizes excluded COD income in a taxable year, the tax attributes attributable to that member (and its direct and indirect subsidiaries to the extent required by section 1017(b)(3)(D) and paragraph (a)(3) of this section), including basis of assets and losses and credits arising in separate return limitation years, shall be reduced as provided in sections 108 and 1017 and this section. Basis of subsidiary stock, however, shall not be reduced below zero pursuant to paragraph (a)(2) of this section (including when subsidiary stock is treated as depreciable property under section 1017(b)(3)(D) when there is an election under section 108(b)(5)).

(ii) *Consolidated tax attributes attributable to a member*. For purposes of this section, the amount of a consolidated tax attribute (*e.g.*, a consolidated net operating loss) that is attributable to a member shall be determined pursuant to the principles of §1.1502–21(b)(2)(iv). In addition, if the member is a member of a separate return limitation year subgroup, the amount of a tax attribute that arose in a separate return limitation year that is attributable to that member shall also be determined pursuant to the principles of §1.1502–21(b)(2)(iv).

(3) *Look-through rules*—(i) *Priority of section 1017(b)(3)(D)*. If a member treats stock of a subsidiary as depreciable property pursuant to section 1017(b)(3)(D), the basis of the depreciable property of such subsidiary shall be reduced pursuant to section 1017(b)(3)(D) prior to the application of paragraph (a)(3)(ii) of this section.

(ii) *Application of additional look-through rule*. If the basis of stock of a corporation (the lower-tier member) that is owned by another corporation (the higher-tier member) is reduced pursuant to sections 108 and 1017 and paragraph (a)(2) of this section (but not as a result of treating subsidiary stock as depreciable property pursuant to section 1017(b)(3)(D)), and both of such corporations are members of the same consolidated group on the last day of the higher-tier member's taxable year that includes the date on which the excluded COD income is realized or the first day of the higher-tier member's taxable year that follows the taxable year that includes the date on which the excluded COD income is realized, solely for purposes of sections 108 and 1017 and this section other than paragraphs (a)(4) and (b)(1) of this section, the lower-tier member shall be treated as realizing excluded COD income on the last day of the taxable year of the higher-tier member that includes the date on which the higher-tier member realized the excluded COD income. The amount of such excluded COD income shall be the amount of such basis reduction. Accordingly, the tax attributes attributable to such lower-tier member shall be reduced as provided in sections 108 and 1017 and this section. To the extent that the excluded COD income realized by the lower-tier member pursuant to this paragraph (a)(3) does not reduce a tax attribute attributable to the lower-tier member, such excluded COD income shall not be applied to reduce tax attributes attributable to any member under paragraph (a)(4) of this section and shall not cause an excess loss account to be taken into account under §1.1502–19(b)(1) and (c)(1)(iii)(B).

(4) *Reduction of certain tax attributes attributable to other members*. To the extent that, pursuant to paragraph (a)(2) of this section, the excluded COD income is not applied to reduce the tax attributes attributable to the member that realizes the excluded COD income, after the application of paragraph (a)(3) of this section, such amount shall be applied to reduce the remaining consolidated tax attributes of the group, other than consolidated tax attributes to which a SRLY limitation applies, as provided in section 108 and this section. Such amount also shall be applied to reduce the tax attributes attributable to members that arose (or are treated as arising) in a separate return limitation year to the extent that the member that realizes excluded COD income is a member of the separate return limitation year subgroup with respect to such attribute if a SRLY limitation applies to the use of such attribute. In addition, such amount shall be applied to reduce the tax attributes attributable to members that arose in a separate return year or that arose (or are treated as arising) in a separate return limitation year if no SRLY limitation applies to the use of such attribute. The reduction of each tax attribute pursuant to the three preceding sentences shall be made in the order prescribed in section 108(b)(2) and pursuant to the principles of §1.1502–21(b)(1). Except as otherwise provided in this paragraph (a)(4), a tax attribute that arose in a separate return year or that arose (or is treated as arising) in a separate return limitation year is not subject to reduction pursuant to this paragraph (a)(4). Basis in assets is not subject to reduction pursuant to this paragraph (a)(4). Finally, to the extent that the realization of excluded COD income by a member pursuant to paragraph (a)(3) does not reduce a tax attribute attributable to such lower-tier member, such excess shall not be applied to reduce tax attributes attributable to any member pursuant to this paragraph (a)(4).

(b) *Special rules*—(1) *Multiple debtor members*—(i) *Reduction of tax attributes attributable to debtor members prior to reduction of consolidated tax attributes*. If in a single taxable year multiple members realize excluded COD income, paragraphs (a)(2) and (3) of this section shall apply with respect to the excluded COD income of each such member before the application of paragraph (a)(4) of this section.

(ii) *Reduction of higher-tier debtor's tax attributes*. If in a single taxable year multiple members realize excluded COD income and one such member is a higher-tier member of another such member, para-

graphs (a)(2) and (3) of this section shall be applied with respect to the excluded COD income of the higher-tier member before such paragraphs are applied to the excluded COD income of the other such member. In applying the rules of paragraph (a)(2) and (3) of this section with respect to the excluded COD income of the higher-tier member, the liabilities that give rise to the excluded COD income of the other such member shall not be treated as discharged for purposes of computing the limitation on basis reduction under section 1017(b)(2). A member (the first member) is a higher-tier member of another member (the second member) if the first member is the common parent or investment adjustments under §1.1502–32 with respect to the stock of the second member would affect investment adjustments with respect to the stock of the first member.

(iii) *Reduction of additional tax attributes*. If more than one member realizes excluded COD income that has not been applied to reduce a tax attribute attributable to such member (the remaining COD amount) and the remaining tax attributes available for reduction under paragraph (a)(4) of this section are less than the aggregate of the remaining COD amounts, after the application of paragraph (a)(2) of this section, each such member's remaining COD amount shall be applied on a *pro rata* basis (based on the relative remaining COD amounts), pursuant to paragraph (a)(4) of this section, to reduce such remaining available tax attributes.

(iv) *Ownership of lower-tier member by multiple higher-tier members*. If stock of a corporation is held by more than one higher-tier member of the group and more than one such higher-tier member reduces its basis in such stock, then under paragraph (a)(3) of this section the excluded COD income resulting from the stock basis reductions shall be applied on a *pro rata* basis (based on the amount of excluded COD income caused by each basis reduction) to reduce the attributes of the corporation.

(v) *Ownership of lower-tier member by multiple higher-tier members in multiple groups*. If a corporation is a member of one group (the first group) on the last day of the first group's higher-tier member's taxable year that includes the date on which that higher-tier member realizes excluded COD income and is a member of another group (the second group) on the following day and the first group's higher-tier member and the second group's higher-tier member both reduce their basis in the stock of such corporation pursuant to sections 108 and 1017 and this section, paragraph (a)(3) of this section shall first be applied in respect of the excluded COD income that results from the reduction of the basis of the corporation's stock owned by the first group's higher-tier member and then shall be applied in respect of the excluded COD income that results from the reduction of the basis of the corporation's stock owned by the second group's higher-tier member.

(2) *Election under section 108(b)(5)*—(i) *Availability of election*. The group may make the election described in section 108(b)(5) for any member that realizes excluded COD income. The election is made separately for each member. Therefore, an election may be made for one member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section) while another election, or no election, may be made for another member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section). See §1.108–4 for rules relating to the procedure for making an election under section 108(b)(5).

(ii) *Treatment of shares with an excess loss account*. For purposes of applying section 108(b)(5)(B), the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.

(3) *Application of section 1017*—(i) *Timing of basis reduction*. Basis of property shall be subject to reduction pursuant to the rules of sections 108 and 1017 and this section after the determination of the tax imposed by chapter 1 of the Internal Revenue Code for the taxable year during which the member realizes excluded COD income and any prior years and coincident with the reduction of other attributes pursuant to section 108 and this section. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is subject to reduction pursuant to sections 108 and 1017 and this section.

(ii) *Limitation of section 1017(b)(2)*. The limitation of section 1017(b)(2) on the reduction in basis of property shall be applied by reference to the aggregate of the basis of the property held by the member that realizes excluded COD income, not the aggregate of the basis of the property held by all of the members of the group, and the liabilities of such member, not the aggregate liabilities of all of the members of the group.

(iii) *Treatment of shares with an excess loss account*. For purposes of applying section 1017(b)(2) and §1.1017–1, the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.

(4) *Application of section 1245*. Notwithstanding section 1017(d)(1)(B), a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of paragraph (a)(3)(ii) of this section.

(5) *Reduction of basis of intercompany obligations and former intercompany obligations*—(i) *Intercompany obligations that cease to be intercompany obligations*. If excluded COD income is realized in a consolidated return year in which an intercompany obligation becomes an obligation that is not an intercompany obligation because the debtor or the creditor becomes a nonmember or because the assets of the creditor are acquired by a nonmember in a transaction to which section 381(a) applies, the basis of such intercompany obligation is not available for reduction in respect of such excluded COD income pursuant to sections 108 and 1017 and this section. However, in such cases, the basis of the debt treated as new debt issued under §1.1502–13(g)(3) is available for reduction in respect of such excluded COD income pursuant to sections 108 and 1017 and this section.

(ii) *Intercompany obligations*. The reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and this section shall not result in the satisfaction and reissuance of the obligation under §1.1502–13(g). Therefore, any income or gain (or reduction of loss or deduction) attributable to a reduction of the basis of an intercompany obligation will be taken into account when §1.1502–13(g)(3) applies to such obligation. Furthermore, §1.1502–13(c)(6)(i) (regarding the treat-

ment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and this section. See §1.1502–13(g)(3)(i)(A) and (ii)(B)(2).

(6) *Taking into account of excess loss account*—(i) *Determination of inclusion*. The determination of whether any portion of an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of §1.1502–19(c)(1)(iii)(B) is made after the determination of the tax imposed by chapter 1 of the Internal Revenue Code for the year during which the member realizes excluded COD income (without regard to whether any portion of an excess loss account in a share of stock of the subsidiary is required to be taken into account) and any prior years, after the reduction of tax attributes pursuant to sections 108 and 1017 and this section, and after the adjustment of the basis of the share of stock of the subsidiary pursuant to §1.1502–32 to reflect the amount of the subsidiary's deductions and losses that are absorbed in the computation of taxable income (or loss) for the year of the disposition and any prior years, and the excluded COD income applied to reduce attributes and the attributes reduced in respect thereof. See §1.1502–11(c) for special rules related to the computation of tax that apply when an excess loss account is required to be taken into account.

(ii) *Timing of inclusion*. To the extent an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of §1.1502–19(c)(1)(iii)(B), such amount shall be included on the group's tax return for the taxable year that includes the date on which the subsidiary realizes such excluded COD income.

(7) *Dispositions of stock*. See §1.1502–11(c) for limitations on the reduction of tax attributes when a member disposes of stock of another member (including dispositions that result from the application of §1.1502–19(c)(1)(iii)(B)) during a taxable year in which any member realizes excluded COD income.

(8) *Departure of member*. If the taxable year of a member (the departing member) during which such member realizes excluded COD income ends on or prior to the last day of the consolidated return year and, on the first day of the taxable year of such member that follows the taxable year during which such member realizes excluded COD income, such member is not a member of the group and does not have a successor member (within the meaning of paragraph (b)(10) of this section), all tax attributes listed in section 108(b)(2) that remain after the determination of the tax imposed that belong to members of the group (including the departing member and subsidiaries of the departing member) shall be subject to reduction as provided in section 108 and the regulations promulgated thereunder (including §1.108–7(c), if applicable) and this section.

(9) *Intragroup reorganization*—(i) *In general*. If the taxable year of a member during which such member realizes excluded COD income ends prior to the last day of the consolidated return year and, on the first day that follows the taxable year of such member during which such member realizes excluded COD income, such member has a successor member, for purposes of applying the rules of sections 108 and 1017 and this section, notwithstanding §1.108–7, the successor member shall be treated as the member that realized the excluded COD income. Thus, all attributes attributable to the successor member listed in section 108(b)(2) (including attributes that were attributable to the successor member prior to the date such member became a successor member) are available for reduction under paragraph (a)(2) of this section.

(ii) *Group structure change*. If a member that realizes excluded COD income acquires the assets of the common parent of the consolidated group in a transaction to which section 381(a) applies and succeeds such common parent under the principles of §1.1502–75(d)(2) as the common parent of the consolidated group, the member's attributes that remain after the determination of tax for the group for the consolidated return year during which the excluded COD income is realized (and any prior years) (including attributes that were attributable to the former common parent prior to the date of the transaction to which section 381(a) applies) shall be available for reduction under paragraph (a)(2) of this section.

(10) *Definition of successor member*. A successor member means a person to which the member that realizes excluded COD income (or a successor member) transfers its assets in a transaction to which section 381(a) applies if such transferee is a member of the group immediately after the transaction.

(11) *Non-application of next day rule*. For purposes of applying the rules of sections 108 and 1017 and this section, the next day rule of §1.1502–76(b)(1)(ii)(B) shall not apply to treat a member's excluded COD income as realized at the beginning of the day following the day on which such member's status as a member changes.

(c) *Examples*. The principles of paragraphs (a) and (b) of this section are illustrated by the following examples. Unless otherwise indicated, no election under section 108(b)(5) has been made and the taxable year of all consolidated groups is the calendar year. The examples are as follows:

Example 1. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiary S1. P owns 80 percent of the stock of S1. In Year 1, the P group sustained a $250 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $125 was attributable to P and $125 was attributable to S1. On Day 1 of Year 2, P acquired 100 percent of the stock of S2, and S2 joined the P group. As of the beginning of Year 2, S2 had a $50 net operating loss carryover from Year 1, a separate return limitation year. In Year 2, the P group sustained a $200 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $90 was attributable to P, $70 was attributable to S1, and $40 was attributable to S2. In Year 3, S2 realized $200 of excluded COD income from the discharge of non-intercompany indebtedness. In that same year, the P group sustained a $50 consolidated net operating loss, of which $40 was attributable to S1 and $10 was attributable to S2 under the principles of §1.1502–21(b)(2)(iv). As of the beginning of Year 4, S2 had Asset A with a fair market value of $10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, Asset A had a basis of $40 and S2 had no liabilities.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S2 must first be reduced to take into account its excluded COD income in the amount of $200.

(*1*) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S2 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating

loss attributable to S2, to $40. Then, again pursuant to section 108(b)(4)(B), S2's net operating loss carryover of $50 from its separate return limitation year is reduced to $0. Finally, the consolidated net operating loss carryover from Year 2 is reduced by $40, the portion of that consolidated net operating loss carryover attributable to S2, to $160.

(*2*) *Reduction of basis*. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S2, S2 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S2 reduces its basis in Asset A by $40, from $40 to $0.

(B) *Reduction of remaining consolidated tax attributes*. The remaining $60 of excluded COD income then reduces consolidated tax attributes pursuant to paragraph (a)(4) of this section. In particular, the remaining $40 consolidated net operating loss for Year 3 is reduced to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20 from $250 to $230. Pursuant to paragraph (a)(4) of this section, a *pro rata* amount of the consolidated net operating loss carryover from Year 1 that is attributable to each of P and S1 is treated as reduced. Therefore, $10 of the consolidated net operating loss carryover from Year 1 that is attributable to each of P and S1 is treated as reduced.

Example 2. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1 and S2. P owns 100 percent of the stock of S1 and S1 owns 100 percent of the stock of S2. None of P, S1, or S2 has a separate return limitation year. In Year 1, the P group sustained a $50 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $10 was attributable to P, $20 was attributable to S1, and $20 was attributable to S2. In Year 2, the P group sustained a $70 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $30 was attributable to P, $30 was attributable to S1, and $10 was attributable to S2. In Year 3, S1 realized $170 of excluded COD income from the discharge of non-intercompany indebtedness. In that same year, the P group sustained a $50 consolidated net operating loss, of which $10 was attributable to S1 and $40 was attributable to S2 under the principles of §1.1502–21(b)(2)(iv). As of the beginning of Year 4, S1's sole asset was the stock of S2, and S2 had Asset A with a $10 value. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, S1 had a $80 basis in the S2 stock, Asset A had a basis of $0, and neither S1 nor S2 had any liabilities.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of $170.

(*1*) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating loss for Year 3 attributable to S1, to $40. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20, the portion of that consolidated net operating loss carryover attributable to S1, to $30, and the consolidated net operating loss carryover from Year 2 is reduced by $30, the portion of that consolidated net operating loss carryover attributable to S1, to $40.

(*2*) *Reduction of basis*. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S2 by $80, from $80 to $0.

(*3*) *Tiering down of stock basis reduction*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing $80 of excluded COD income. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S2 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is reduced by an additional $40, the portion of the consolidated net operating loss for Year 3 attributable to S2, to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20, the portion of that consolidated net operating loss carryover attributable to S2, to $10. Then, the consolidated net operating loss carryover from Year 2 is reduced by $10, the portion of that consolidated net operating loss carryover attributable to S2, to $30. S2's remaining $10 of excluded COD income does not reduce consolidated tax attributes attributable to P or S1 under paragraph (a)(4) of this section.

(B) *Reduction of remaining consolidated tax attributes*. Finally, pursuant to paragraph (a)(4) of this section, S1's remaining $30 of excluded COD income reduces the remaining consolidated tax attributes. In particular, the remaining $10 consolidated net operating loss carryover from Year 1 is reduced by $10 to $0, and the remaining $30 consolidated net operating loss carryover from Year 2 is reduced by $20 to $10.

Example 3. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of S1, S1 owns 100 percent of the stock of S2, and S2 owns 100 percent of the stock of S3. None of P, S1, S2, or S3 had a separate return limitation year prior to Year 1. In Year 1, the P group sustained a $150 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $50 was attributable to S2, and $100 was attributable to S3. In Year 2, the P group sustained a $50 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $40 was attributable to S1 and $10 was attributable to S2. In Year 3, S1 realized $170 of excluded COD income from the discharge of non-intercompany indebtedness. In that same year, the P group sustained a $50 consolidated net operating loss, of which $10 was attributable to S1, $20 was attributable to S2, and $20 was attributable to S3 under the principles of §1.1502–21(b)(2)(iv). At the beginning of Year 4, S1's only asset was the stock of S2, and S2's only asset was the stock of S3 with a value of $10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, S1's stock of S2 had a basis of $120 and S2's stock of S3 had a basis of $180. In addition, none of S1, S2, and S3 had any liabilities.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of $170.

(*1*) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryovers attributable to S1 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating loss attributable to S1, to $40. Then, the consolidated net operating loss carryover from Year 2 is reduced by $40, the portion of that consolidated net operating loss carryover attributable to S1, to $10.

(*2*) *Reduction of basis*. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S2 by $120, from $120 to $0.

(B) *Tiering down of stock basis reduction to S2*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing $120 of excluded COD income. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S2 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S2, to $20. Then, the consolidated net operating loss carryover from Year 1 is reduced by $50, the portion of that consolidated net operating loss carryover attributable to S2, to $100. Then, the consolidated net operating loss carryover from Year 2 is further reduced by $10, the portion of that consolidated net operating loss carryover attributable to S2, to $0. Following the reduction of the net operating loss and the net operating loss carryovers attributable to S2, S2 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S2 reduces its basis in its S3 stock by $40 to $140.

(C) *Tiering down of stock basis reduction to S3*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing $40 of excluded COD income. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and the net operating loss carryovers attributable to S3 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S3, to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $20, the lesser of the portion of that consolidated net operating loss carryover attributable to S3 and the remaining excluded COD income, to $80.

Example 4. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of

each of S1 and S2. Each of S1 and S2 owns stock of S3 that represents 50 percent of the value of the stock of S3. None of P, S1, S2, or S3 had a separate return limitation year prior to Year 1. In Year 1, the P group sustained a $160 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $10 was attributable to P, $50 was attributable to S2, and $100 was attributable to S3. In Year 2, the P group sustained a $110 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $40 was attributable to S1 and $70 was attributable to S2. In Year 3, S1 realized $200 of excluded COD income from the discharge of non-intercompany indebtedness, and S2 realized $270 of excluded COD income from the discharge of non-intercompany indebtedness. In that same year, the P group sustained a $50 consolidated net operating loss, of which $10 was attributable to S1, $20 was attributable to S2, and $20 was attributable to S3 under the principles of §1.1502–21(b)(2)(iv). At the beginning of Year 4, S3 had one asset with a value of $10. After the computation of tax imposed for Year 3 and before the application of sections 108 and 1017 and this section, S1's basis in its S3 stock was $60, S2's basis in its S3 stock was $120, and S3's asset had a basis of $200. In addition, none of S1, S2, and S3 had any liabilities.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtors*. Pursuant to paragraph (b)(1)(i) of this section, the tax attributes attributable to each of S1 and S2 are reduced pursuant to paragraph (a)(2) of this section. Then, pursuant to paragraph (a)(3) of this section, the tax attributes attributable to S3 are reduced so as to reflect a reduction of S1's and S2's basis in the stock of S3. Then, paragraph (a)(4) is applied to reduce additional tax attributes.

(*1*) *Reduction of net operating losses generally*. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating losses and the net operating loss carryovers attributable to S1 and S2 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B).

(*2*) *Reduction of net operating losses attributable to S1*. The consolidated net operating loss for Year 3 is reduced by $10, the portion of the consolidated net operating loss attributable to S1, to $40. Then, the consolidated net operating loss carryover from Year 2 is reduced by $40, the portion of that consolidated net operating loss carryover attributable to S1, to $70.

(*3*) *Reduction of net operating losses attributable to S2*. The consolidated net operating loss for Year 3 is also reduced by $20, the portion of the consolidated net operating loss attributable to S2, to $20. Then, the consolidated net operating loss carryover from Year 1 is reduced by $50, the portion of that consolidated net operating loss carryover attributable to S2, to $110. Then, the consolidated net operating loss carryover from Year 2 is reduced by $70, the portion of that consolidated net operating loss carryover attributable to S2, to $0.

(*4*) *Reduction of basis*. Following the reduction of the net operating losses and the net operating loss carryovers attributable to S1 and S2, S1 and S2 must reduce their basis in their assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S3 by $60, from $60 to $0, and S2 reduces its basis in the stock of S3 by $120, from $120 to $0.

(B) *Tiering down of basis reduction*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing $180 of excluded COD income. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and the net operating loss carryovers attributable to S3 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 3 is further reduced by $20, the portion of the consolidated net operating loss attributable to S3, to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by $100, the portion of that consolidated net operating loss carryover attributable to S3, to $10. Following the reduction of the net operating loss and the net operating loss carryover attributable to S3, S3 reduces its basis in its asset pursuant to section 1017 and §1.1017–1. Accordingly, S3 reduces its basis in its asset by $60, from $200 to $140.

(C) *Reduction of remaining consolidated tax attributes*. Finally, pursuant to paragraph (a)(4) of this section, the remaining $90 of S1's excluded COD income and the remaining $10 of S2's excluded COD income reduce the remaining consolidated tax attributes. In particular, the remaining $10 consolidated net operating loss carryover from Year 1 is reduced by $10 to $0. Because that amount is less than the aggregate amount of remaining excluded COD income, such income is applied on a *pro rata* basis to reduce the remaining consolidated tax attributes. Accordingly, $9 of S1's remaining excluded COD income and $1 of S2's remaining excluded COD income is applied to reduce the remaining consolidated net operating loss carryover from Year 1. Consequently, of S1's excluded COD income of $200, only $119 is applied to reduce tax attributes, and, of S2's excluded COD income of $270, only $261 is applied to reduce tax attributes.

Example 5. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P owns 100 percent of the stock of S1 and S2, and S1 owns 100 percent of the stock of S3. None of P, S1, S2, or S3 has a separate return limitation year prior to Year 1. In Year 1, the P group sustained a $90 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $10 was attributable to P, $15 was attributable to S1, $20 was attributable to S2, and $45 was attributable to S3. On January 1 of Year 2, P realized $140 of excluded COD income from the discharge of non-intercompany indebtedness. On December 31 of Year 2, S1 issued stock representing 50 percent of the vote and value of its outstanding stock to a person that was not a member of the group. As a result of the issuance of stock, S1 and S3 ceased to be members of the P group. For the consolidated return year of Year 2, the P group sustained a $60 consolidated net operating loss, of which $5 was attributable to S1, $40 was attributable to S2, and $15 was attributable to S3 under the principles of §1.1502–21(b)(2)(iv). As of the beginning of Year 3, P's only assets were the stock of S1 and S2, S1's sole asset was the stock of S3, S2 had Asset A with a value of $10, and S3 had Asset B with a value of $10. After the computation of tax imposed for Year 2 and before the application of sections 108 and 1017 and this section, P had a $80 basis in the S1 stock and a $50 basis in the S2 stock, S1 had a $80 basis in the S3 stock, and Asset A and B each had a basis of $10. In addition, none of P, S1, S2, and S3 had any liabilities.

(ii) *Analysis*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to P must first be reduced to take into account its excluded COD income in the amount of $140.

(A) *Reduction of net operating losses*. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryover attributable to P under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss carryover from Year 1 is reduced by $10, the portion of that consolidated net operating loss carryover attributable to P, to $80.

(B) *Reduction of basis*. Following the reduction of the net operating loss and the net operating loss carryover attributable to P, P reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, P reduces its basis in the stock of S1 by $80, from $80 to $0, and its basis in the stock of S2 by $50, from $50 to $0.

(C) *Tiering down of stock basis reduction to S1*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S1 is treated as realizing $80 of excluded COD income, despite the fact that it ceases to be a member of the group at the end of the day on December 31 of Year 2. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S1 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by $5, the portion of the consolidated net operating loss for Year 2 attributable to S1, to $55. Then, the consolidated net operating loss carryover from Year 1 is reduced by an additional $15, the portion of that consolidated net operating loss carryover attributable to S1, to $65. Following the reduction of the net operating loss and the net operating loss carryover attributable to S1, S1 reduces its basis in its assets pursuant to section 1017 and §1.1017–1. Accordingly, S1 reduces its basis in the stock of S3 by $60, from $80 to $20.

(D) *Tiering down of stock basis reduction to S2*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S2 is treated as realizing $50 of excluded COD income. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S2 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by an additional $40, the portion of the consolidated net operating loss for Year 2 attributable to S2, to $15. Then, the consolidated net operating loss carryover from Year 1 is reduced by an additional $10, a portion of the consolidated net operating loss carryover attributable to S2, to $55.

(E) *Tiering down of stock basis reduction to S3*. Pursuant to paragraph (a)(3) of this section, for purposes of sections 108 and 1017 and this section, S3 is treated as realizing $60 of excluded COD income (by reason of S1's reduction in its basis of its S3 stock). Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, therefore, the net operating loss and net operating loss carryovers attributable to S3 under

the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by an additional $15, the portion of the consolidated net operating loss for Year 2 attributable to S3, to $0. Then, the consolidated net operating loss carryover from Year 1 is reduced by an additional $45, the portion of that consolidated net operating loss carryover attributable to S3, to $10.

Example 6. (i) *Facts*. P1 is the common parent of a consolidated group that includes subsidiaries S1, S2, and S3. P1 owns 100 percent of the stock of S1 and S2. S1 owns 100 percent of the stock of S3. None of P1, S1, S2, or S3 has a separate return limitation year prior to Year 1. In Year 1, the P1 group sustained a $120 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $40 was attributable to P1, $35 was attributable to S1, $30 was attributable to S2, and $15 was attributable to S3. On January 1 of Year 2, S3 realized $65 of excluded COD income from the discharge of non-intercompany indebtedness. On June 30 of Year 2, S3 issued stock representing 80 percent of the vote and value of its outstanding stock to P2, the common parent of another group. As a result of the issuance of stock, S3 ceased to be a member of the P1 group and became a member of the P2 group. For the consolidated return year of Year 2, the P1 group sustained a $50 consolidated net operating loss, of which $5 was attributable to S1, $40 was attributable to S2, and $5 was attributable to S3 under the principles of §1.1502–21(b)(2)(iv). As of the beginning of its taxable year beginning on July 1 of Year 2, S3's sole asset was Asset A with a $10 value. After the computation of tax imposed for Year 2 on the P1 group and before the application of sections 108 and 1017 and this section and the computation of tax imposed for Year 2 on the P2 group, Asset A had a basis of $0. In addition, S3 had no liabilities. On January 1 of Year 3, P1 sold all of its stock of S1.

(ii) *Analysis*—(A) *Reduction of tax attributes attributable to debtor*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S3 must first be reduced to take into account its excluded COD income in the amount of $65. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryover attributable to S3 under the principles of §1.1502–21(b)(2)(iv) are reduced in the order prescribed by section 108(b)(4)(B). Accordingly, the consolidated net operating loss for Year 2 is reduced by $5, the portion of the consolidated net operating loss for Year 2 attributable to S3, to $45. Then, the consolidated net operating loss carryover from Year 1 is reduced by $15, the portion of that consolidated net operating loss carryover attributable to S3, to $105.

(B) *Reduction of remaining consolidated tax attributes*. Pursuant to paragraphs (a)(4) and (b)(8) of this section, S3's remaining $45 of excluded COD income reduces the remaining consolidated tax attributes in the P1 group. In particular, the remaining $45 consolidated net operating loss for Year 2 is reduced by an additional $45 to $0.

(C) *Basis Adjustments*. For purposes of computing P1's gain or loss on the sale of the S1 stock in Year 3, P1's basis in its S1 stock will reflect a net positive adjustment of $40, which is the excess of the amount of S3's excluded COD income that is applied to reduce attributes ($65) over the reduction of S1's and S3's attributes in respect of such excluded COD income ($25).

Example 7. (i) *Facts*. P is the common parent of a consolidated group that includes subsidiaries S1 and S2. P owns 100 percent of the stock of S1, and S1 owns 100 percent of the stock of S2. None of P, S1, or S2 has a separate return limitation year prior to Year 1. In Year 1, the P group sustained a $50 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $10 was attributable to P, $20 was attributable to S1, and $20 was attributable to S2. On January 1 of Year 2, S1 realized $55 of excluded COD income from the discharge of non-intercompany indebtedness. On June 30 of Year 2, P transferred all of its assets to S1 in a transaction to which section 381(a) applied. As a result of that transaction, pursuant to §1.1502–75(d)(2)(ii), S1 succeeded P as the common parent of the group. Pursuant to §1.1502–75(d)(2)(iii), S1's taxable year closed on the date of the acquisition. However, P's taxable year did not close. On the consolidated return for Year 2, the group sustained a $50 consolidated net operating loss. Under the principles of §1.1502–21(b)(2)(iv), of that amount, $10 was attributable to S1 for its taxable year that ended on June 30, $15 was attributable to S1 as the successor of P, and $25 was attributable to S2.

(ii) *Analysis*. Pursuant to paragraph (a)(2) of this section, the tax attributes attributable to S1 must first be reduced to take into account its excluded COD income in the amount of $55. For this purpose, S1's attributes that remain after the determination of tax for the group for Year 2 are subject to reduction. Pursuant to section 108(b)(2)(A) and paragraph (a) of this section, the net operating loss and the net operating loss carryover attributable to S1 under the principles of §1.1502–21(b)(2)(iv) are reduced. Accordingly, the consolidated net operating loss for Year 2 is reduced by $25, the portion of the consolidated net operating loss for Year 2 attributable to S1, to $25. Then, the consolidated net operating loss carryover from Year 1 is reduced by $30, the portion of that consolidated net operating loss carryover attributable to S1 (which includes the portion attributable to P), to $20.

(d) *Effective dates*. This section applies to discharges of indebtedness that occur after March 21, 2005. Groups, however, may apply this section in whole, but not in part, to discharges of indebtedness that occur on or before March 21, 2005, and after August 29, 2003. For discharges of indebtedness occurring on or before March 21, 2005, and after August 29, 2003, with respect to which a group chooses not to apply this section, see §1.1502–28T as contained in 26 CFR part 1 revised as of April 1, 2004. Furthermore, groups may apply paragraph (b)(4) of this section to discharges of indebtedness that occur on or before August 29, 2003, in cases in which section 1017(b)(3)(D) was applied.

§1.1502–28T [Removed]

Par. 10. Section 1.1502–28T is removed.

Par. 11. Section 1.1502–32 is amended as follows:

1. Paragraph (b)(1)(ii) is redesignated as paragraph (b)(1)(iii).

2. New paragraph (b)(1)(ii) is added.

3. Paragraphs (b)(3)(ii)(C)(*1*) and (b)(3)(iii)(A) are revised.

4. Paragraph (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) are revised.

5. Paragraph (h)(7) is revised.

The addition and revisions read as follows:

§1.1502–32 Investment adjustments.

* * * * *

(b) * * *

(1) * * *

(ii) *Special rule for discharge of indebtedness income*. Adjustments under this section resulting from the realization of discharge of indebtedness income of a member that is excluded from gross income under section 108(a) (excluded COD income) and from the reduction of attributes in respect thereof pursuant to sections 108 and 1017 and §1.1502–28 (including reductions in the basis of property) when a member (the departing member) ceases to be a member of the group on or prior to the last day of the consolidated return year that includes the date the excluded COD income is realized are made immediately after the determination of tax for the group for the taxable year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the taxable year of the departing member following the taxable year during which the excluded COD income is realized. Such adjustments when a corporation (the new member) is not a member of the group on the last day of the consolidated return year that includes the date the excluded COD income is realized but is a member of the group at the beginning of the following consolidated return year are also made immediately after the determination of tax for the group for the taxable year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the taxable year of the new member

following the taxable year during which the excluded COD income is realized. If the new member was a member of another group immediately before it became a member of the group, such adjustments are treated as occurring immediately after it ceases to be a member of the prior group.

* * * * *

(3) * * *

(ii) * * *

(C) * * *

(*1*) *In general*. Excluded COD income is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes attributable to any member of the group under section 108, section 1017 or §1.1502–28. However, if S is treated as realizing excluded COD income pursuant to §1.1502–28(a)(3), S shall not be treated as realizing excluded COD income for purposes of the preceding sentence.

* * * * *

(iii) * * *

(A) *In general*. S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (*e.g.*, under section 172 or 1212) attributable to S expires or is reduced under section 108(b) and §1.1502–28, it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, when a tax attribute attributable to S is reduced as required pursuant to §1.1502–28(a)(3), the reduction of the tax attribute is not treated as a noncapital, nondeductible expense of S. Finally, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

* * * * *

(5) * * *

(ii) * * *

Example 4. Discharge of indebtedness. (a) *Facts*. P forms S on January 1 of Year 1 and S borrows $200. During Year 1, S's assets decline in value and the P group has a $100 consolidated net operating loss. Of that amount, $10 is attributable to P and $90 is attributable to S under the principles of §1.1502–21(b)(2)(iv). None of the loss is absorbed by the group in Year 1, and S is discharged from $100 of indebtedness at the close of Year 1. P has a $0 basis in the S stock. P and S have no attributes other than the consolidated net operating loss. Under section 108(a), S's $100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502–28, the consolidated net operating loss is reduced to $0.

(b) *Analysis*. Under paragraph (b)(3)(iii)(A) of this section, the reduction of $90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense in Year 1 because that loss is permanently disallowed by section 108(b) and §1.1502–28. Under paragraph (b)(3)(ii)(C)(*1*) of this section, all $100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a $100 reduction to the consolidated net operating loss. Consequently, the loss and the cancellation of the indebtedness result in a net positive $10 adjustment to P's basis in its S stock.

(c) *Insufficient attributes*. The facts are the same as in paragraph (a) of this *Example 4*, except that S is discharged from $120 of indebtedness at the close of Year 1. Under section 108(a), S's $120 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502–28, the consolidated net operating loss is reduced by $100 to $0 after the determination of tax for Year 1. Under paragraph (b)(3)(iii)(A) of this section, the reduction of $90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C)(*1*) of this section, only $100 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. The remaining $20 of discharge of indebtedness income excluded from gross income under section 108(a) has no effect on P's basis in S's stock.

* * * * *

(h) * * *

(7) *Rules related to discharge of indebtedness income excluded from gross income*. Paragraphs (b)(1)(ii), (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) of this section apply with respect to determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) after March 21, 2005. However, groups may apply those provisions with respect to determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) on or before March 21, 2005, and after August 29, 2003. For determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) on or before March 21, 2005, and after August 29, 2003, with respect to which a group chooses not to apply paragraphs (b)(1)(ii), (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) of this section, see §1.1502–32T(b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4*, paragraphs (a), (b), and (c) as contained in 26 CFR part 1 revised as of April 1, 2004.

Par. 12. Section 1.1502–32T is amended as follows:

1. Paragraph (a)(3) is added.

2. Paragraphs (b) through (b)(3)(iii)(B) are revised.

3. Paragraphs (b)(5)(i) through (h)(5)(ii) are revised.

4. Paragraph (h)(7) is revised.

The revisions read as follows:

§1.1502–32T Investment adjustments (temporary).

* * * * *

(a)(3) through (b)(3)(iii)(B) [Reserved]. For further guidance, see §1.1502–32(a)(3) through (b)(3)(iii)(B).

* * * * *

(b)(5)(i) through (h)(5)(ii) [Reserved]. For further guidance, see §1.1502–32(b)(5)(i) through (h)(5)(ii).

* * * * *

(h)(7) [Reserved]. For further guidance, see §1.1502–32(h)(7).

Par. 13. In §1.1502–76, paragraph (b)(1)(ii)(B)(*3*) is revised to read as follows:

§1.1502–76 Taxable year of members of group.

* * * * *

(b) * * *

(1) * * *

(ii) * * *

(B) * * *

(*3*) Whether the allocation is inconsistent with other requirements under the Internal Revenue Code and regulations promulgated thereunder (*e.g.*, if a section 338(g) election is made in connection with a group's acquisition of S, the deemed asset sale must take place before S becomes a member and S's gain or loss with respect to its assets must be taken into account by S as a nonmember (but see §1.338–1(d)), or if S realizes discharge of indebtedness

income that is excluded from gross income under section 108(a) on the day it becomes a nonmember, the discharge of indebtedness income must be treated as realized by S as a member (see §1.1502–28(b)(11)); and

* * * * *

Par. 14. In §1.1502–80, the second sentence of paragraph (c) is revised to read as follows:

§1.1502–80 Applicability of other provisions of law.

* * * * *

(c) * * * See §§1.1502–11(d) and 1.1502–35T for additional rules relating to stock loss. * * *

* * * * *

Par. 15. In §1.1502–80T, the third sentence of paragraph (c) is revised to read as follows:

§1.1502–80T Applicability of other provisions of law (temporary).

* * * * *

(c) * * * See §§1.1502–11(d) and 1.1502–35T for additional rules relating to stock loss. * * *

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved March 10, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 21, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 22, 2005, 70 F.R. 14395)

Section 6103.—Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103(j)(1)–1: Disclosures of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

T.D. 9188

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Disclosure of Return Information to the Bureau of the Census

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTIONS: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to additions to the list of items of return information disclosed to the Bureau of the Census (Bureau). The regulation adds two items of return information for use in producing demographic statistics programs, including the Bureau's Small Area Income and Poverty Estimates (SAIPE). The temporary regulations also remove four items that the Bureau has indicated are no longer necessary. The text of these temporary regulations serves as the text of the proposed regulations (REG–147195–04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective March 10, 2005.

Applicability Date: For dates of applicability, see §301.6103(j)(1)–1T(e).

FOR FURTHER INFORMATION CONTACT: James O'Leary, (202) 622–4580 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Under section 6103(j)(1), upon written request from the Secretary of Commerce, the Secretary of the Treasury is to furnish to the Bureau return information that is prescribed by Treasury regulations for the purpose of, but only to the extent necessary in, structuring censuses and national economic accounts and conducting related statistical activities authorized by law. Section 301.6103(j)(1)–1 of the regulations further defines such purposes by reference to 13 U.S.C. chapter 5 and provides an itemized description of the return information authorized to be disclosed for such purposes.

This document adopts temporary regulations that authorize the IRS to disclose the additional items of return information that have been requested by the Secretary of Commerce to the extent necessary in developing and preparing demographic statistics, including statutorily mandated Small Area Income and Poverty Estimates (SAIPE). The temporary regulations also remove certain items of return information that are enumerated in the existing regulations but that the Secretary of Commerce has indicated are no longer needed.

Temporary regulations in this issue of the Bulletin amend the Procedure and Administration Regulations (26 CFR Part 301) relating to Internal Revenue Code (Code) section 6103(j)(1). The temporary regulations contain rules relating to the disclosure of return information reflected on returns to officers and employees of the Department of Commerce for structuring censuses and national economic accounts and conducting related statistical activities authorized by law.

Explanation of Provisions

By letter dated May 11, 2004, the Department of Commerce requested that additional items of return information be disclosed to the Bureau for purposes related to conducting the SAIPE program and used to estimate the number of school-aged children in poverty for each of the over 14,000 districts in the United States. Specifically, the Department of Commerce requested Earned Income and the number of Earned Income Tax Credit-eligible qualifying children. The request indicates that under the Improving America's Schools Act of 1994 (Public Law 103–382, 108 Stat. 3518 (October 20, 1994)), these estimates were mandated biennially, and under the No Child Left Behind Act of 2002 (Public Law 107–110, 115 Stat. 1425 (January 8, 2002)), they are required annually.

The regulations also remove four items of return information that the Bureau indicated it no longer requires. These items are: end-of-year code; months actively operated; total number of documents and the

total amount reported on the Form 1096 (*Annual Summary and Transmittal of U.S. Information Returns*) transmitting Forms 1099–MISC (*Miscellaneous Income*); and Form 941 (*Employer's Quarterly Federal Tax Return*) indicator and business address on Schedule C (*Profit or Loss From Business*) of Form 1040. Accordingly, the temporary regulations have removed these items from the enumeration of return information to be disclosed to the Bureau.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these temporary regulations is James C. O'Leary, Office of the Associate Chief Counsel (Procedure & Administration), Disclosure and Privacy Law Division.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR Part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read in part, as follows:

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

Section 301.6103(j)(1)–1T also issued under 26 U.S.C. 6103(j)(1); * * *

Par. 2. Section 301.6103(j)(1)–1 is amended by revising paragraphs (b)(1) introductory text and (b)(3) introductory text to read as follows:

§301.6103(j)(1)–1 Disclosures of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

* * * * *

(b)(1) [Reserved]. For further guidance, see §301.6103(j)(1)–1T(b)(1)

* * * * *

(b)(3) [Reserved]. For further guidance, see §301.6103(j)(1)–1T(b)(3).

* * * * *

Par. 3. Section 301.6103(j)(1)–1T is added to read as follows:

§301.6103(j)(1)–1T Disclosures of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities (temporary).

(a) [Reserved]. For further guidance, see §301.6103(j)(1)–1(a).

(b) Disclosure of return information reflected on returns to officers and employees of the Bureau of the Census.

(1) Officers or employees of the Internal Revenue Service will disclose the following return information reflected on returns of individual taxpayers to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of title 13, United States Code, intercensal estimates of population and income for all geographic areas included in the population estimates program and demographic statistics programs, censuses, and related program evaluation:

(i) Taxpayer identity information (as defined in section 6103(b)(6) of the Internal Revenue Code), validity code with respect to the taxpayer identifying number (as described in section 6109), and taxpayer identity information of spouse and dependents, if reported.

(ii) Location codes (including area/district office and campus/service center codes).

(iii) Marital status.

(iv) Number and classification of reported exemptions.

(v) Wage and salary income.

(vi) Dividend income.

(vii) Interest income.

(viii) Gross rent and royalty income.

(ix) Total of—

(A) Wages, salaries, tips, etc.;

(B) Interest income;

(C) Dividend income;

(D) Alimony received;

(E) Business income;

(F) Pensions and annuities;

(G) Income from rents, royalties, partnerships, estates, trusts, etc.;

(H) Farm income;

(I) Unemployment compensation; and

(J) Total Social Security benefits.

(x) Adjusted gross income.

(xi) Type of tax return filed.

(xii) Entity code.

(xiii) Code indicators for Form 1040, Form 1040 (Schedules A, C, D, E, F, and SE), and Form 8814.

(xiv) Posting cycle date relative to filing.

(xv) Social Security benefits.

(xvi) Earned Income (as defined in section 32(c)(2)).

(xvii) Number of Earned Income Tax Credit-eligible qualifying children.

(b)(2) [Reserved]. For further guidance, see §301.6103(j)(1)–1(b)(2).

(b)(3) Officers or employees of the Internal Revenue Service will disclose the following business related return information reflected on returns of taxpayers to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of title 13, United States Code, demographic and economic statistics programs, censuses, and surveys. (The "returns of taxpayers" include, but are not limited to: Form 941; Form 990 series; Form 1040 series and Schedules C and SE; Form 1065 and all attending schedules and Form 8825; Form 1120 series and all attending schedules and Form 8825; Form 851; Form 1096; and other business returns, schedules and forms that the Internal Revenue Service may issue.):

(i) Taxpayer identity information (as defined in section 6103(b)(6)) including parent corporation, shareholder, partner, and employer identity information.

(ii) Gross income, profits, or receipts.

(iii) Returns and allowances.

(iv) Cost of labor, salaries, and wages.

(v) Total expenses or deductions.

(vi) Total assets.

(vii) Beginning- and end-of-year inventory.

(viii) Royalty income.

(ix) Interest income, including portfolio interest.

(x) Rental income, including gross rents.

(xi) Tax-exempt interest income.

(xii) Net gain from sales of business property.

(xiii) Other income.

(xiv) Total income.

(xv) Percentage of stock owned by each shareholder.

(xvi) Percentage of capital ownership of each partner.

(xvii) Principal industrial activity code, including the business description.

(xviii) Consolidated return indicator.

(xix) Wages, tips, and other compensation.

(xx) Social Security wages.

(xxi) Deferred wages.

(xxii) Social Security tip income.

(xxiii) Total Social Security taxable earnings.

(xxiv) Gross distributions from employer-sponsored and individual retirement plans from Form 1099–R.

(b)(4) through (b)(6) [Reserved]. For further guidance, see §301.6103(j)(1)–1(b)(4) through (b)(6).

(c) through (d) [Reserved]. For further guidance, see §301.6103(j)(1)–1(c) and (d).

(e) *Effective date*. This section is applicable to disclosures to the Bureau of the Census on or after March 10, 2005.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved February 26, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 10, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 11, 2005, 70 F.R. 12140)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2005. See Rev. Rul. 2005-23, page 864.

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.601: Rules and regulations.
(Also Part I, §§ 25, 103, 143; 1.25–4T, 1.103–1, 6a.103A–2.)

Rev. Proc. 2005–22

SECTION 1. PURPOSE

This revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5).

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of § 141). Section 141(e) provides that the term "qualified bond" includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the applicable volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of § 143; (iii) the issue does not meet the private business tests of paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of $250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) imposes eligibility requirements concerning the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of § 143(f). Generally, under §§ 143(f)(1) and 25(c)(2)(A)(iii)(IV), these income requirements are met only if all owner-financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. Under § 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term "applicable median family income" means the greater of (A) the area median gross income for the area in which the residence is located, or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued, and nonissued bond amounts elected, after December 31, 1988. *See* § 4005(h) of the Technical and Miscellaneous Revenue Act of 1988, 1988–3 C.B. 1, 311 (1988).

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on February 11, 2005, and may be obtained by calling the HUD reference service at 1–800–245–2691. The income information is also available at HUD's World Wide Web site, *http:huduser.org/datasets/il.html*, which provides a menu from which you may select the year and type of data of interest. The Internal Revenue Service annually publishes the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on February 28, 2005, in Rev. Proc. 2005–15, 2005–9 I.R.B. 638.

SECTION 3. APPLICATION

.01 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use $58,000 as the median gross income for the United States. *See* § 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income figures released by HUD on February 11, 2005. *See* § 2.06 of this revenue procedure.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 2004–24, 2004–16 I.R.B. 790, is obsolete except as provided in § 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86–124, 1986–2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86–124 to the general approach taken in this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in section 3 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on February 11, 2005, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding section 5.01 of this revenue procedure, issuers may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 2004–24 with respect to bonds originally sold and nonissued bond amounts elected not later than May 11, 2005, if the commitments or purchases described in § 5.01 are made not later than July 10, 2005.

DRAFTING INFORMATION

The principal author of this revenue procedure is David White of the Office of Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities). For further information regarding this revenue procedure, contact Mr. White at (202) 622–3980 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Disclosure of Return Information to the Bureau of the Census

REG–147195–04

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In this issue of Bulletin, the IRS is issuing temporary regulations (T.D. 9188) relating to additions to, and deletions from, the list of items of return information disclosed to the Bureau of the Census (Bureau) for use in producing demographic statistics programs, including the Bureau's Small Area Income and Poverty Estimates (SAIPE). These temporary regulations provide guidance to IRS personnel responsible for disclosing the information. The text of these temporary regulations published in this issue of the Bulletin serves as the text of the proposed regulations.

DATES: Written and electronic comments and requests for a public hearing must be received by June 9, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–147195–04), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–147195–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site at: *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–147195–04).

FOR FURTHER INFORMATION CONTACT: Concerning submission of comments, Treena Garrett, (202) 622–7180 (not a toll-free number); concerning the temporary regulations, James O'Leary, (202) 622–4580 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Under section 6103(j)(1), upon written request from the Secretary of Commerce, the Secretary of the Treasury is to furnish to the Bureau of the Census (Bureau) return information that is prescribed by Treasury regulations for the purpose of, but only to the extent necessary in, structuring censuses and national economic accounts and conducting related statistical activities authorized by law. Section 301.6103(j)(1)–1 of the regulations provides an itemized description of the return information authorized to be disclosed for this purpose. Periodically, the disclosure regulations are amended to reflect the changing needs of the Bureau for data for its statutorily authorized statistical activities.

This document contains proposed regulations authorizing IRS personnel to disclose additional items of return information that have been requested by the Secretary of Commerce, and to remove certain items of return information that are enumerated in the existing regulations but that the Secretary of Commerce has indicated are no longer needed.

Temporary regulations in this issue of the Bulletin amend the Procedure and Administration Regulations (26 CFR Part 301) relating to Internal Revenue Code (Code) section 6103(j). The temporary regulations contain rules relating to the disclosure of return information reflected on returns to officers and employees of the Department of Commerce for structuring censuses and national economic accounts and conducting related statistical activities authorized by law.

The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the proposed regulations.

Special Analyses

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

Comments and Requests for a Public Hearing

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

Drafting Information

The principal author of these regulations is James C. O'Leary, Office of the Associate Chief Counsel (Procedure & Administration), Disclosure and Privacy Law Division.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended in part, by adding an entry in numerical order to read as follows:

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

Section 301.6103(j)(1)–1 also issued under 26 U.S.C. 6103(j)(1); * * *

Par. 2. In §301.6103(j)(1)–1 paragraphs (b)(1), (b)(3), and (e) are revised to read as follows:

§301.6103(j)(1)–1 Disclosure of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

* * * * *

(b) [The text of proposed paragraphs (b)(1), (b)(3) and (e) are the same as the text of §301.6103(j)(1)–1T(b)(1), (b)(3) and (e) published elsewhere in this issue of the Bulletin].

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on March 10, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 11, 2005, 70 F.R. 12166)

Foundations Status of Certain Organizations

Announcement 2005–24

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

Aetep International Education Foundation, Framingham, MA
African Virtual University International, Washington, DC
American Charitable Investment Fund, Detroit, MI
American International Foundation of Budapest, Inc., Hungary
Americans for Peace and Justice in South Asia, Takoma Park, MD
Angel Ministries, Monroe, LA
Ann Arbor IT Zone, Ann Arbor, MI
Artreach, Inc., Chicago, IL
Ascension Mission Corporation, Washington, DC
Asian Bodytherapy Institute, Sausalito, CA
Avalon Winter Guard, Inc., Waukesha, WI
B B L International Teen Services, Inc., Baltimore, MD
Bentley Schmoke Memorial Scholarship Fund, Baltimore, MD
Benue Aids Council, Inc., Minneapolis, MN
Bethesda Lakes, Inc., St. Louis, MO
Big Bear Lake Rotary Club Foundation, Big Bear Lake, CA
Bilderback Lacrosse Foundation, Inc., Severna Park, MD
Bitpogs Kids, Inc., Baltimore, MD
Bloomfield Raiders Youth Football, Inc., Bloomfield, CT
Blue-Gray R A F, Bellaire, OH
Boffo, Inc., Los Osos, CA
Boricua Link, Chicago, IL
Boys & Girls Club of Cass County, Cassopolis, MI
Brandywine Charter School, Inc., Wilmington, DE
Brave, Inc., Berlin, MD
Brian's Neurofibromatosis Foundation, Indianapolis, IN
Bridgeway Counseling Services, Columbia, MD
Bristol Trainstation Foundation, Bristol, VA
C C R New Beginnings Foundation, Ellendale, DE
Cambridge MHA Education & Charitable Corporation, Cambridge, OH
Capital Area Housing Corporation, Potomac, MD
Catherine Popesco Foundation for the Arts, Santa Monica, CA
Center for Educational Partnerships, Chicago, IL
Center for Special Community Services, Inc., Brooklyn, NY
Centerville Volunteers Fire Fighters Association, Centerville, IA
Central Illinois Biomedical Research Group, Inc., Peoria, IL
Change Agent Programs, Inc., Orlando, FL
Change Group, Madison, WI
Chesapeake Youth Chorale, Inc., Centreville, MD
Chicago Military Academy Bronzeville Association, Chicago, IL
Chicago School Leadership Development Corporation, Chicago, IL
Children First Early Childhood Home Education, Inc., Oak Park, IL
Childrens Day Care, Riverdale, IL
Chocolate Affair, Inc., Los Angeles, CA
Christian Community Youth Board, Inc., Salem, IN
Christian Satellite Bible College, Maywood, IL
Christian Scholarship Foundation, Inc., Altoona, IA
Citizens Cornerstone Commission of Wood River, Wood River, IL
Civic, Salisbury, MO
Clark Conservatory Music and Arts, Detroit, MI
Clark County Youth Programs, Inc., New Albany, IN
Clark Elementary School PTA, Washington, DC
Cleveland Filmworks, Cleveland, OH
Columbia Weavers and Spinners Guild, Columbia, MO
Community Education Enhancement, Inc., Chula Vista, CA
Connecting Classrooms to the World, Evanston, IL
Counsel for Palestinian Restitution and Reparation, Inc., Washington, DC
Crown Me Beautiful Arts Foundation, San Diego, CA
Cuba for Kids Foundation, Inc., Miami, FL
Cure MS Now Research Fund, Corte Madera, CA
Dallas Street Community Development Corp., Baltimore, MD
Delta Development, Incorporated, St. Louis, MO
Detroit Area Council of Teachers of Mathematics, Grosse Pointe, MI
Diamond Life, Baltimore, MD
District of Columbia Public Charter School Facilities Corporation, Washington, DC
Dominica Association of Midwestern USA, Chicago, IL

Don Lugo Conquistador Foundation, Chino, CA
Dubuque Audubon Society, Dubuque, IA
Dynamic Directions, Des Plaines, IL
Eastern Shore Heritage, Inc., Chestertown, MD
Eastside Community Policing Partnership, Detroit, MI
Edwardsville Childrens Museum, Inc., Edwardsville, IL
Eleventh Commission, Inc., Fort Wayne, IN
Elite Performing Company, Inc., Indianapolis, IN
Emergency Support of Central Nebraska, Inc., Grand Island, NE
Emmas Place for Homeless Women and Children, Chicago, IL
Ensemble Polaris, St. Paul, MN
Ethel Somerstein Memorial Foundation, Inc., Flushing, NY
Experiential Learning Assessment Network, Mc Lean, VA
Exposition Park West Asset Leasing Corporation, Inglewood, CA
Farmington Area Education Foundation, Farmington, MI
Fathers House Ministries, Matoon, IL
Federal Hill Main Street, Inc., Baltimore, MD
Ford County Consortium Educational Foundation, Dodge City, KS
Foundation for Children and Family Support Services, Inc., Murphysboro, IL
Fountain of Youth, Flint, MI
Friends of Fun Shop Foundation, Springfield, IL
Friends of McGregor Public Library, Highland Park, MI
Friends of Reed Middle School Bridgman, MI, Bridgman, MI
Fuhrmann Middle School Booster Club, Sterling Heights, MI
Globe of America, Sherman Oaks, CA
God's Grace, Salisbury, MD
Grazette Halfway House, Inc., Lake Park, FL
Greater Kansas City Gay and Lesbian Youth Services, Inc., Kansas City, MO
Greenway on the Red Trust, Inc., Fargo, ND
Guajome Park Academy Foundation, Vista, CA
Hartge Nautical Museum, Galesville, MD
Helix Home Healthcare and Hospice Services, Inc., Columbia, MD
Heritage Communities Re-Development Company, Winthrop Harbor, IL
His Hands Ministries Cedar Rapids Iowa Endowment Foundation, Inc., Marion, IA
Home Management Beautification Community Services, Chicago, IL
House of Sophia, San Diego, CA
Illinois Vipassana Association, Rockford, IL
Illinois World War II Memorial Project, Springfield, IL
Illume Productions, Inc., New York, NY
In the Light, Troy, MI
Indiana State School Music Association, Inc., Indianapolis, IN
Innerlife Ministries, Inc., Grandview, MO
Insight Through Art Foundation, Inc., Chicago, IL
Institute for SME Finance, Washington, DC
Inwood Heights Housing Development Fund Corporation, Bronx, NY
Iowa Valley Community School District Foundation, Marengo, IA
Isaiah Films, Winston Salem, NC
Isiserettes Drill & Drum Corps, Inc., Des Moines, IA
J. Edward Gilliland Geneva Rotary Foundation, Geneva, OH
Jefferson City Rotary West Endowment Fund, Jefferson City, MO
Joan Metah Masterson Hospitality House Foundation, Ventor City, NJ
Kansas Film Culture Development Society, Olathe, KS
Karna, Incorporated, Peoria, IL
Key City Rotary Club Foundation, Dubuque, IA
Keyhole Players, Chicago, IL
Kiraw Productions, Inc., Snellville, GA
Lacy Alana West Memorial Scholarship Fund, Steelville, MO
Lend-A-Hand Foundation, Lanham, MD
Lew Wasserman Scholarship Foundation, Los Angeles, CA
LHS Band-Orchestra Boosters, Ludington, MI
Life Center of Prayer, Burnsville, MN
Life Challenges Foundation, Inc., South Bend, IN
Lorain County Mission, Elyria, OH
Luhtanen Howes Charitable Foundation, Inc., Livonia, MI
Marshall Heights, Inc., Sioux City, IA
Mascoutah Cemetary Chapel, Inc., Mascoutah, IL
Maywood Baseball League, Inc., Hammond, IN
Measuagoon, Inc., Dallas, TX
Midwest Avian Adoption & Rescue Services, Inc., Stillwater, MN
Milwaukee Choral Artists, Inc., Shorewood, WI
Minds Institute, Farmington Hills, MI
Missouri Association of Community Development Corporations, Jefferson City, MO
Montesorri After School Program Corporation, Chicago, IL
Mount Olivet Housing and Community Development Corporation, Richmond, VA
Nancy Ferro Learning for Life Foundation, Easton, MD
Native American Finance Officers Association, Inc., Denver, CO
Native American Intertribal Veterans Memorial Foundation, Wichita, KS
Net, Inc., Wapakoneta, OH
Neutral Ground, Inc., Cary, IL
Nevus Link, Maryland Heights, MO
New Life Community Services, Inc., University Park, IL
North Akron Wrestling Club, Stow, OH
Northfield Historical Society, Northfield, IL
Northwestern Minnesota Health Care Purchasing Alliance, Crookston, MN
Oak Glen, Inc., Sioux Falls, SD
Oak Ridge Assisted Living of Hastings, Saint Paul, MN
Obadiah Association, Inc., Akron, OH
Obrien County Kinship, Inc., Sheldon, IA
On Our Owne of Anne Arundel County, Inc., Annapolis, MD
Original Willing Workers Society, Inc., Southfield, MI
Orleans Community Enhancement Corporation, Orleans, IN
Oro Institute & Library NPC, St. Anthony, MN
Our Lady of Charity, St. Louis, MO
Outreach Youth Services, Chicago, IL
Ozark Sermon Psalms, Perryville, MO
Pacific Springs Village, Omaha, NE
Pana Education Foundation, Pana, IL
Parents and Children First of Lucas County, Charitan, IA
Parrot Mountain Ranch, Inc., Ranchita, CA
PHS Track and Cross Country Foundation, Inc., Poway, CA
Platte Valley Heritage Foundation, Kearney, NE
Pocomoke Children & Family Services Collaborative, Inc., Pocomoke City, MD

Potential Developing Ministries, Inc., Lawrenceville, GA
Prayer Works, Holland, MI
Prevention Center for a Drug-Free Community, Chillicothe, MO
Prince Georges Junior Golf Association, Inc., Fort Washington, MD
Project Prevention & Intervention, St. Louis, MO
Quilts for Comfort, Inc., Newark, DE
Ralph Jones Youth Center, Inc., Fort Wayne, IN
Readers Room Club, Orland Park, IL
Reno County Angels, Inc., Hutchinson, KS
Robbins Historical Society and Museum, Robbins, IL
Rubicon Foundation Trust, St. Louis, MO
Safety Mentoring Network, Inc., Evergreen Park, IL
San Miguel Scholarship Foundation, Chicago, IL
Seaford Lions Foundation, Inc., Seaford, DE
Senior Cybernet, Inc., Bloomington, IN
Seven Circles Heritage Center of Central Illinois Foundation, Tonica, IL
Solid Rock Academy, Inc., Port Sulphur, LA
Somali Community Center of Orange County, Anaheim, CA
South Bend Youth Symphony Orchestras, Inc., South Bend, IN
Southern Illinois Foundation for Living History & Education, Mount Vernon, IL
St. Anne Foundation for Excellence in Education, Inc., St. Anne, IL
St. Charles High School Boosters Club, St. Charles, IL
St. Louis Case Management, St. Louis, MO
Stages of History, Inc., Nevada, MO
Strategic Management Association, Naperville, IL
Sunrise Ecopolis Foundation, Inc., St. George, UT
Tanner-Foster Educational Foundation, Topeka, KS
Tecumseh Youth Theatre, Tecumseh, MI
Tennessee Football Coaches Association, Kingsport, TN
Three Stepping Stones, Inc., Vienna, IL
Tierra Del Sol Regional Library Network, Riverside, CA
Tommy Jane House, Inc., Adelphi, MD
Twin Cities Bronze, Lakeville, MN
United Way of Lapeer County, Lapeer, MI
Universal Charter Schools Corporation, Santa Ana, CA
Urban Age Institute, Washington, DC
USD 286 Educational Foundation, Sedan, KS
Vagabond Ministries, Franklin, TN
Victory House, Chicago, IL
Video Machete, Chicago, IL
Vision in Progress for Palatine and Inverness, Palatine, IL
Volunteer Mounted Patrol, Inc., Glen Arm, MD
Whitmore Lake Community Soccer Association, Inc., Whitmore Lake, MI
Wildspaces, Portland, MI
Wing Feirie Theatre, St. Paul Park, MN
Womens Cultural Collaborative, Detroit, MI
Youth Encouragement Systems, Linden, MI
Youth Extensional Services, Inc., Milwaukee, WI
Youthvision, Englewood, CO

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Loss Limitation Rules; Correction

Announcement 2005-25

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document corrects final regulations (T.D. 9187, 2005–13 I.R.B. 778) that were published in the **Federal Register** on Thursday, March 3, 2005 (70 FR 10319), that disallows certain losses recognized on sales of subsidiary stock by members of a consolidated group.

DATES: This correction is effective on April 4, 2005.

FOR FURTHER INFORMATION CONTACT: Theresa Abell, (202) 622–7700 or Martin Huck, (202) 622–7750 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations (T.D. 9187) that is the subject of this correction is under sections 337(d) and 1502 of the Internal Revenue Code.

Need for Correction

As published, T.D. 9187 contains an error that may prove to be misleading and is in need of clarification.

* * * * *

Correction of Publication

Accordingly, 26 CFR Part 1 is corrected by making the following correcting amendment:

PART 1 – INCOME TAXES

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

Authority: 26 USC 7805 * * *

§1.1502–20 [Corrected]

Section 1.1502–20(i)(3)(viii), second sentence, the language "Any reapportionment of a section 382 limitation made pursuant to the previous sentence shall have the effects described in paragraphs (i)(3)(iii)(D)(*ii*) and (*iii*) of this section." is removed and the language "Any reapportionment of a section 382 limitation made pursuant to the previous sentence shall have the effects described in paragraph (i)(3)(iii)(D)(*2*) and (*3*) of this section." is added in its place.

Cynthia E. Grigsby,
Acting Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedures and Administration).

(Filed by the Office of the Federal Register on March 24, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 25, 2005, 70 F.R. 15227)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–27 through 2004–52 is in Internal Revenue Bulletin 2004–52, dated December 27, 2004.