December 18, 2008.

Michele M. Leonhart,

Acting Administrator.

[FR Doc. E8–30800 Filed 12–24–08; 8:45 am]

BILLING CODE 4410–09–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 180

Consolidated HUD Hearing Procedures for Civil Rights Matters

CFR Correction

In title 24 of the Code of Federal Regulations, parts 0 to 199, revised as of April 1, 2008, on pages 733 and 734, in § 180.670, remove paragraphs (b)(3)(iii)(A) through (b)(3)(iii)(C).

[FR Doc. E8–30942 Filed 12–24–08; 8:45 am]

BILLING CODE 1505–01–D

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9442]

RIN 1545–BA11

Consolidated Returns; Intercompany Obligations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1502 of the Internal Revenue Code (Code). The regulations provide guidance regarding the treatment of transactions involving obligations between members of a consolidated group. These final regulations will affect affiliated groups of corporations filing consolidated returns.

DATES: *Effective Date:* These regulations are effective on *December 24, 2008*.

Applicability Date: For dates of applicability, see §§ 1.1502–13(g)(8) and 1.1502–28(d).

FOR FURTHER INFORMATION CONTACT: Frances Kelly, (202) 622–7770 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 28, 2007, the IRS and the Treasury Department published a notice of proposed rulemaking (REG–107592–00) in the **Federal Register** (72 FR 55139) (the 2007 Proposed Regulations) which proposed to amend § 1.1502–13(g) (regarding the treatment of transactions involving obligations between members of a consolidated group) and to add § 1.1502–13(e)(2)(ii)(C) (regarding the treatment of certain transactions involving the provision of insurance between members of a consolidated group). The 2007 Proposed Regulations replaced an earlier proposal (REG–105964–98) [63 FR 70354], published in the **Federal Register** on December 21, 1998, which was withdrawn.

On February 25, 2008, the IRS and the Treasury Department published a notice (Announcement 2008–25) in the **Federal Register** (73 FR 9972) withdrawing the portion of the 2007 Proposed Regulations relating to the treatment of intercompany insurance transactions. No public hearing regarding the remaining portion of the 2007 Proposed Regulations was requested or held. However, written, electronic, and oral comments were received. After consideration of all of the comments, the 2007 Proposed Regulations are adopted as revised by this Treasury decision. The principal comments and changes are discussed in this preamble.

Explanation of Provisions

Former Regulations Under § 1.1502–13(g) (the Former Regulations)

An intercompany obligation is generally defined as an obligation between members of a consolidated group, but only for the period during which both the creditor and debtor are members of the group. The Former Regulations under § 1.1502–13(g) (the 1995 regulations and the 1998 proposed regulations, as in effect before these final regulations), prescribe rules relating to the treatment of transactions involving such obligations, and apply generally to three broad categories of transactions; transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation (inbound transactions), transactions in which an intercompany obligation ceases to be an intercompany obligation (outbound transactions), and transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions).

For all three types of transactions, the intercompany obligation is treated as satisfied and, if it remains outstanding, reissued as a new obligation (the deemed satisfaction-reissuance model).

Significant Changes Made by the 2007 Proposed Regulations

The 2007 Proposed Regulations make several significant changes to the Former Regulations, principally with respect to intragroup and outbound transactions.

First, the 2007 Proposed Regulations simplify the mechanics of the deemed satisfaction-reissuance model by separating the deemed transactions from the actual transaction. In general, the new model deems the following sequence of events to occur immediately before, and independently of, the actual transaction: (i) the debtor is deemed to satisfy the obligation for a cash amount equal to the obligation's fair market value, and (ii) the debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount. The parties are then treated as engaging in the actual transaction but with the new obligation.

Second, the 2007 Proposed Regulations provide that for transactions where it is appropriate to require a deemed satisfaction and reissuance, the intercompany obligation generally should be deemed satisfied and reissued for its fair market value (rather than issue price determined under the original issue discount principles of sections 1273 and 1274).

Third, the 2007 Proposed Regulations narrow the scope of intragroup and outbound transactions that trigger the deemed satisfaction-reissuance model by providing a number of exceptions to its application. A deemed satisfaction and reissuance generally is not required for these excepted transactions either because it is not necessary to apply the deemed satisfaction-reissuance model to carry out the purposes of § 1.1502–13(g) or because the burdens associated with valuing the obligation or applying the mechanics of the deemed satisfaction-reissuance model outweigh the benefits achieved by its application.

Finally, the 2007 Proposed Regulations include two anti-abuse rules, the ''material tax benefit rule'' and the ''off-market issuance rule,'' which are intended to prevent distortions of consolidated taxable income resulting from the shifting of built-in items from intercompany obligations, or from the issuance of obligations at a materially off-market rate of interest through the manipulation of a member's tax attributes or stock basis. These rules are aimed at intragroup transactions otherwise excepted from the deemed satisfaction-reissuance model (to ensure that the exceptions cannot be used to distort consolidated taxable income through intragroup transactions) and similar direct lending transactions.

General Comments

In general, commentators have been supportive of the 2007 Proposed Regulations, particularly with respect to the simplified mechanics of the deemed satisfaction-reissuance model and the availability of exceptions to its application. However, concerns have been raised regarding the application of the material tax benefit rule and the off-market issuance rule. The principal comments made with respect to these rules and other significant provisions, as well as the changes made in the final regulations in response to these comments, are discussed in this preamble.

A. Anti-Abuse Rules

As proposed, the material tax benefit rule generally applies to an intragroup assignment or extinguishment otherwise excepted from the deemed satisfaction-reissuance model. Under this rule, if, at the time of the assignment or extinguishment, it is reasonably foreseeable that the shifting of built-in items from an intercompany obligation between members will secure a material tax benefit, the intercompany transaction will be subject to the deemed satisfaction-reissuance model.

The proposed off-market issuance rule generally applies if an intercompany obligation is issued at a materially off-market rate of interest, and at the time of issuance, it is reasonably foreseeable that the shifting of built-in items from the obligation will secure a material tax benefit. In such cases, the intercompany obligation will be treated as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor member and the debtor member, as appropriate (for example, as a distribution or a contribution to capital).

While acknowledging certain benefits of the ''reasonably foreseeable'' test, commentators believed that it would be difficult to apply because the results of the test would not be easily determined. These commentators suggested that, for purposes of determining the applicability of each of the rules, the ''reasonably foreseeable'' test be replaced with a test that placed more emphasis on the intent of the parties at the time of the transaction (or issuance). Specifically, they recommended that the rules apply if ''a principal purpose'' of the transaction (or the issuance) was to secure a material tax benefit. If such a test were adopted, the commentators also thought it appropriate to provide certain pro-government presumptions in cases where the facts surrounding the transaction suggested such intent.

These final regulations adopt the commentators' suggestions that the rules should be ''intent-based.'' However, consistent with other consolidated return anti-abuse rules, these final regulations provide that the rules' application will be determined based upon a ''with a view'' standard and eliminate the requirement that the tax benefit to be secured by the transaction (or issuance) be material. In addition, because the IRS and the Treasury Department remain concerned about distortions that could result from transfers of intercompany obligations in section 351 exchanges that are excepted from the deemed satisfaction and reissuance model, these final regulations also adopt more specific rules regarding such transfers (described in part C.3.a. of this Preamble).

B. Deemed Satisfaction and Reissuance for Fair Market Value

Commentators were generally supportive of the 2007 Proposed Regulations' use of fair market value as the amount for which an intercompany obligation is deemed satisfied and reissued. However, commentators also noted the difficulty in valuing intercompany obligations. Based upon these comments, the IRS and the Treasury Department are continuing to study whether it is appropriate to include certain simplifying presumptions in determining value, and comments are requested in this regard.

C. Exceptions and Related Provisions

1. Overlap of Exceptions and Deemed Exchanges Under § 1.1001–3

The 2007 Proposed Regulations provide a number of special rules for transactions in which intercompany debt is exchanged for newly issued intercompany debt. With respect to these intragroup debt-for-debt exchanges, the newly issued obligation generally is treated as issued for its fair market value, and the intercompany debt is deemed satisfied and reissued for its fair market value.

Commentators questioned whether this latter rule applied only in cases in which the intragroup debt-for-debt exchange involved a single issuer or also in cases in which the obligations had different issuers. The requirement is intended to apply in both such cases. Because the language of the 2007 Proposed Regulations encompasses both of these situations, this rule has been retained without change.

However, the 2007 Proposed Regulations also contain an exception to the deemed satisfaction-reissuance model for certain routine debt modifications involving a single issuer (the routine modification exception). This exception applies if all of the rights and obligations under an intercompany obligation are extinguished in an exchange (or deemed exchange under § 1.1001–3) for a newly issued intercompany obligation, and the issue price of the new obligation equals both the adjusted issue price and basis of the extinguished obligation.

In addition to the routine modification exception, the 2007 Proposed Regulations except from the deemed satisfaction-reissuance model many transactions that involve the assumption of a debtor member's obligations under an intercompany obligation (for example, an assumption of an intercompany obligation in connection with an intercompany nonrecognition transaction). A number of commentators noted that, in some cases, these assumption transactions also may be a significant modification of the instrument resulting in a deemed exchange under § 1.1001–3. In such cases, commentators questioned how the deemed exchange interacted with the various exceptions to the deemed satisfaction-reissuance model.

The IRS and the Treasury Department believe that a deemed exchange under § 1.1001–3 that results from an assumption transaction should be subject to the same set of rules and exceptions as apply to an actual two-party exchange of a debt instrument. Thus, even if the assumption transaction is excepted from the deemed satisfaction-reissuance model, any deemed exchange resulting from the assumption would be a triggering transaction potentially subject to the model. However, in most such cases the deemed exchange will generally qualify for the routine modification exception and thus not require a deemed satisfaction-reissuance.

Accordingly, these final regulations clarify that the routine modification exception applies to a deemed exchange of intercompany debt for intercompany debt that occurs under § 1.1001–3 as a result of an assumption transaction. Specifically, these final regulations provide that, solely for purposes of this exception, a newly issued intercompany obligation will include an obligation that is issued (or deemed issued) by a member other than the original debtor if such other member assumes the original debtor's obligations in certain excepted transactions (intercompany nonrecognition exchanges or intercompany taxable assumption transactions), and the assumption results in a significant modification and deemed exchange under § 1.1001–3.

2. Exception for Intercompany Taxable Assumption Transactions

The 2007 Proposed Regulations provide an exception to the application of the deemed satisfaction-reissuance model for certain intercompany sales or dispositions of assets where intercompany obligations are assumed as part of the transaction. This exception was intended to apply only in the case of a taxable sale (or other taxable disposition) of assets. Commentators noted, however, that the 2007 Proposed Regulations may be read to apply to nonrecognition transactions as well as taxable transactions. The IRS and the Treasury Department agree with the commentators and have revised the regulation to reflect its intended scope. However, as discussed in this preamble, these final regulations also clarify that the exception for certain section 351 nonrecognition exchanges is available for transactions in which a debtor's obligation is assumed.

3. Intercompany Nonrecognition Exchange Exceptions

The 2007 Proposed Regulations provide an exception to the deemed satisfaction-reissuance model for intercompany exchanges to which section 332 or 361 apply if neither the creditor nor the debtor recognize an amount of income, gain, deduction, or loss in the transaction, or in intercompany exchanges to which section 351 applies if no such amount is recognized by the creditor.

a. Section 351 Exception

Commentators questioned whether the exception for section 351 exchanges is available only for transactions in which a creditor assigns an intercompany obligation or if it also is available for transactions in which a debtor's obligation under an intercompany obligation is assumed. The exception is intended to apply to both such transactions. Consistent with the exception for intercompany exchanges under section 332 and section 361, these final regulations revise the exception for intercompany exchanges under section 351 by providing that it will apply only if neither the creditor nor the debtor recognizes an amount.

In addition, because the IRS and the Treasury Department believe that the assignment by a creditor of an intercompany obligation in an intercompany section 351 exchange presents significant potential for distortion, these final regulations limit the availability of the exception for certain of these section 351 transactions. These transactions generally involve exchanges where the transferor or transferee member has a unique tax attribute or special status, where the transferee member issues preferred stock in the exchange, or where the stock of the transferee member (or the stock of a direct or indirect owner of the transferee member) is disposed of within a short period after the exchange.

b. Scope of Exception Under Section 332.

With respect to intercompany exchanges under section 332, commentators requested clarification as to the scope of the exception, particularly with respect to the requirement that no amount be recognized in the exchange. Accordingly, these final regulations revise the exception to provide that it applies to exchanges to which both section 332 and section 337(a) apply in which no amount is recognized by either the creditor or debtor member.

c. Gain or Loss With Respect to an Intercompany Obligation.

The exception to the deemed satisfaction-reissuance model for intercompany exchanges under sections 332, 351, and 361 generally is available if no amount of income, gain, deduction or loss is recognized. Commentators questioned whether this exception was available only where the amount recognized was with respect to the intercompany obligation. The requirement that no amount be recognized in the exchange applies to amounts recognized with respect to all assets. In exchanges where amounts are recognized, the fair market value of all assets (including the intercompany obligation) must be determined. In such cases, the IRS and the Treasury Department do not believe it is unduly burdensome to require a deemed satisfaction and reissuance. Accordingly, these final regulations retain the language of the 2007 Proposed Regulations.

4. Outbound Exception for Intercompany Obligations Newly-Issued in a Reorganization

The 2007 Proposed Regulations provide an exception to the deemed satisfaction-reissuance model for the outbound transfer of an intercompany obligation that is newly issued in an intragroup reorganization and pursuant to the plan of reorganization, is distributed to a nonmember shareholder or creditor in a transaction to which section 361(c) applies. Commentators generally supported this exception but also suggested that, under similar circumstances, an exception be added to apply to certain intercompany distributions of an intercompany obligation if the obligation is transferred outside of the group within a relatively short period of time.

The IRS and the Treasury Department are continuing to study the effects of the deemed satisfaction-reissuance model on such intercompany distributions in conjunction with a broader study regarding the interaction of section 361 and the intercompany transaction rules. Accordingly, these final regulations do not include the suggested exception. However, the IRS and the Treasury Department request further comments in this regard.

5. Exceptions to the Application of Section 108(e)(4)

The 2007 Proposed Regulations retain the exceptions in the Former Regulations for transactions involving an obligation that becomes (in the context of an inbound transaction) or became (in the context of an intragroup or outbound transaction), an intercompany obligation by reason of an event described in § 1.108–2(e). In general, these events are: (1) Acquisitions of indebtedness with a stated maturity date within one year of the acquisition date if the indebtedness is retired on or before that date (the ''short-term debt exception''); and (2) acquisitions of indebtedness by a dealer that acquires and disposes of the indebtedness in the ordinary course of its business of dealing in securities (the ''dealer exception'').

The short-term debt exception is premised upon the view that imposition of the deemed satisfaction-reissuance model is unwarranted because the indebtedness would be retired within the short term by its own terms (and the retirement would produce the same results as that of the deemed satisfaction and reissuance). With respect to the dealer exception, because the indebtedness' status as an intercompany obligation is likely transitory, the burden associated with the deemed satisfaction-reissuance model does not warrant its application.

One commentator questioned whether the short-term debt exception is appropriate because the intragroup retirement of the instrument may produce items that differ in character from those that would be obtained if the instrument were subject to the deemed satisfaction-reissuance model upon entering the group. For example, if a depreciated obligation is deemed satisfied and reissued immediately after it enters the group, the attributes of the creditor's loss and the debtor's discharge of indebtedness income are determined on a separate entity basis. However, if the instrument is excepted from the deemed satisfaction-reissuance model when it enters the group, the subsequent retirement of the note may result, arguably, in a character match of the creditor's and debtor's items. In cases where the adjusted issue price and basis of the note differ in amount, the potential for differing results is amplified. Therefore, the IRS and the Treasury Department agree that the short term debt exceptions for both inbound and intragroup transactions should be eliminated in these final regulations. The dealer exception has been retained in these final regulations.

Consistent with the Former Regulations' treatment of inbound transactions, the 2007 Proposed Regulations treat the attributes of the debtor and creditor member's items from the deemed satisfaction on a separate entity basis. The IRS and the Treasury Department continue to believe that separate entity treatment is appropriate for such inbound transactions.

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 is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses, and, moreover, that any burden on taxpayers is minimal. Therefore, 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 Internal Revenue Code, the notice of proposed rulemaking preceding these regulations 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 Frances Kelly, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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. * * *

Sections 1.1502–13 and 1.1502–28 also issued under 26 U.S.C. 1502. * * *

■ **Par. 2.** Section 1.1502–13 is amended by:

■ 1. Revising the heading and the entries for § 1.1502–13(g)(5) in paragraph (a)(6)(ii).

■ 2. Revising the first sentence of paragraph (e)(2)(i).

■ 3. Revising paragraph (g).

■ 4. Removing paragraph (j)(9) *Example (5)(c).*

The revisions read as follows:

§ 1.1502–13 Intercompany transactions.

(a) * * *

(6) * * *

(ii) * * *

Obligations of members. (§ 1.1502–13(g)(7)(ii))

Example 1. Interest on intercompany obligation.

Example 2. Intercompany obligation becomes nonintercompany obligation.

Example 3. Loss or bad debt deduction with respect to intercompany obligation.

Example 4. Intercompany nonrecognition transactions.

Example 5. Assumption of intercompany obligation.

Example 6. Extinguishment of intercompany obligation.

Example 7. Exchange of intercompany obligations.

Example 8. Tax benefit rule.

Example 9. Issuance at off-market rate of interest.

Example 10. Nonintercompany obligation becomes intercompany obligation.

Example 11. Notional principal contracts.

* * * * *

(e) * * *

(2) * * * (i) * * * Except as provided in paragraph (g)(4)(v) of this section (deferral of items from an intercompany obligation), a member's addition to, or reduction of, a reserve for bad debts that is maintained under section 585 is taken into account on a separate entity basis. * * *

* * * * *

(g) *Obligations of members*—(1) *In general.* In addition to the general rules of this section, the rules of this paragraph (g) apply to intercompany obligations.

(2) *Definitions.* For purposes of this section, the following definitions apply—

(i) *Obligation of a member* is a debt or security of a member.

(A) *Debt of a member* is any obligation of the member constituting indebtedness under general principles of Federal income tax law (for example, under nonstatutory authorities, or under section 108, section 163, or § 1.1275–1(d)), but not an executory obligation to purchase or provide goods or services.

(B) *Security of a member* is any security of the member described in section 475(c)(2)(D) or (E), and any commodity of the member described in section 475(e)(2)(A), (B), or (C), but not if the security or commodity is a position with respect to the member's stock. See paragraphs (f)(4) and (f)(6) of this section for special rules applicable to positions with respect to a member's stock.

(ii) *Intercompany obligation* is an obligation between members, but only for the period during which both parties are members.

(iii) *Intercompany obligation subgroup* is comprised of two or more members that include the creditor and debtor on an intercompany obligation if the creditor and debtor bear the relationship described in section 1504(a)(1) to each other through an intercompany obligation subgroup parent.

(iv) *Intercompany obligation subgroup parent* is the corporation (including either the creditor or debtor) that bears the same relationship to the other members of the intercompany obligation subgroup as a common parent bears to the members of a consolidated group. Any reference to an intercompany obligation subgroup parent includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction to which section 381(a) applies.

(v) *Tax benefit* is the benefit of, for Federal tax purposes, a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. A tax benefit includes, but is not limited to, the use of a built-in item or items from an intercompany obligation to reduce gain or increase loss on the sale of member stock, or to create or absorb a tax attribute of a member or subgroup.

(vi) *Eighty-percent chain* is a chain of two or more corporations in which stock meeting the requirements of section 1504(a)(2) of each lower-tier member is held directly by a higher-tier member of such chain.

(3) *Deemed satisfaction and reissuance of intercompany obligations in triggering transactions*—(i) *Scope*—(A) *Triggering transactions.* For purposes of this paragraph (g)(3), a triggering transaction includes the following:

(*1*) *Assignment and extinguishment transactions.* Any intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation or any comparable transaction in which a member realizes any such amount, directly or indirectly, from an intercompany obligation (for example, a mark to fair market value of an obligation or a bad debt deduction). However, a reduction of the basis of an intercompany obligation pursuant to § 1.1502–36(d) (attribute reduction to prevent duplication of loss), or pursuant to sections 108 and 1017 and § 1.1502–28 (basis reductions upon the exclusion from gross income of discharge of indebtedness) or any other provision that adjusts the basis of an intercompany obligation as a substitute for income, gain, deduction, or loss, is not a comparable transaction.

(*2*) *Outbound transactions.* Any transaction in which an intercompany obligation becomes an obligation that is not an intercompany obligation.

(B) *Exceptions.* Except as provided in paragraph (g)(3)(i)(C) of this section, a transaction is not a triggering transaction as described in paragraph (g)(3)(i)(A) of this section if any of the exceptions in this paragraph (g)(3)(i)(B) apply. In making this determination, if a creditor or debtor realizes an amount in a transaction in which a creditor assigns all or part of its rights under an intercompany obligation to the debtor, or a debtor assigns all of or part of its obligations under an intercompany obligation to the creditor, the transaction will be treated as an extinguishment and will be excepted from the definition of ''triggering transaction'' only if either of the exceptions in paragraphs (g)(3)(i)(B)(*5*) or (*6*) of this section apply. The exceptions are as follows.

(*1*) *Intercompany section 361, 332, or 351 exchange.* The transaction is an intercompany exchange to which section 361(a), sections 332 and 337(a), or (except as provided in the following sentence) section 351 applies in which no amount of income, gain, deduction or loss is recognized by the creditor or debtor. The assignment of an intercompany obligation by a creditor member in an intercompany exchange to which section 351 applies is a triggering transaction, notwithstanding the preceding sentence, if a member of the group is described in, or engages in a transaction that is described in, any of the following paragraphs.

(*i*) The transferor or transferee member has a loss subject to a limitation (for example, a loss from a separate return limitation year that is subject to limitation under § 1.1502–21(c), or a dual consolidated loss that is subject to limitation under § 1.1503(d)–4), but only if the other member is not subject to a comparable limitation;

(*ii*) The transferor or transferee member has a special status within the meaning of § 1.1502–13(c)(5) (for example, a bank defined in section 581, or a life insurance company subject to tax under section 801) that the other member does not also possess;

(*iii*) A member of the group realizes discharge of indebtedness income that is excluded from gross income under section 108(a) within the same taxable year as that of the exchange, and the tax attributes attributable to either the transferor or the transferee member are reduced under sections 108, 1017, and § 1.1502–28 (except if the attribute reduction results solely from the application of § 1.1502–28(a)(4) (reduction of certain tax attributes attributable to other members));

(*iv*) The transferee member has a nonmember shareholder;

(*v*) The transferee member issues preferred stock to the transferor member in exchange for the assignment of the intercompany obligation; or

(*vi*) The stock of the transferee member (or a higher-tier member other than a higher-tier member of an 80-percent chain that includes the transferee) is disposed of within 12 months from the assignment of the intercompany obligation, unless at the time of the assignment, the transferor member, transferee member (or in the case of successive section 351 exchanges, each transferor and transferee member) and the debtor member are all in the same 80-percent chain; and all of the stock of the transferee (or in the case of successive section 351 exchanges, the lowest-tier transferee) held by members of the group is disposed of as part of the same plan or arrangement, either directly or indirectly, to persons that are not members of the group.

(*2*) *Intercompany assumption transaction.* All of the debtor's obligations under an intercompany obligation are assumed in connection with the debtor's sale or other disposition of property (other than solely money) in an intercompany transaction in which gain or loss is recognized under section 1001.

(*3*) *Exception to the application of section 108(e)(4).* The obligation became an intercompany obligation by reason of an event described in § 1.108–2(e)(2) (exception to the application of section 108(e)(4) in the case of acquisitions by securities dealers).

(*4*) *Reserve accounting.* The amount realized is from reserve accounting under section 585 (see paragraph (g)(4)(v) of this section for special rules).

(*5*) *Intercompany extinguishment transaction.* All or part of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction (other than an exchange or deemed exchange of an intercompany obligation for a newly issued intercompany obligation), the adjusted issue price of the obligation is equal to the creditor's basis in the obligation, and the debtor's corresponding item and the creditor's intercompany item (after taking into account the special rules of paragraph (g)(4)(i)(C) of this section) with respect to the obligation offset in amount.

(*6*) *Routine modification of intercompany obligation.* All of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction that is an exchange (or deemed exchange) for a newly issued intercompany obligation, and the issue price of the newly issued obligation equals both the adjusted issue price of the extinguished obligation and the creditor's basis in the extinguished obligation. Solely for purposes of the preceding sentence, a newly issued intercompany obligation includes an obligation that is issued (or deemed issued) by a member other than the original debtor if such other member assumes the original debtor's obligations under the original obligation in a transaction that is described in either paragraph (g)(3)(i)(B)(*1*) or (g)(3)(i)(B)(*2*) of this section and the assumption results in a significant modification of the original obligation under § 1.1001–3(e)(4) and a deemed exchange under § 1.1001–3(b).

(*7*) *Outbound distribution of newly issued intercompany obligation.* The intercompany obligation becomes an obligation that is not an intercompany obligation in a transaction in which a member that is a party to the reorganization exchanges property in pursuance of the plan of reorganization for a newly issued intercompany obligation of another member that is a party to the reorganization and distributes such intercompany obligation to a nonmember shareholder or nonmember creditor in a transaction to which section 361(c) applies.

(*8*) *Outbound subgroup exception.* The intercompany obligation becomes an obligation that is not an intercompany obligation in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the intercompany obligation, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.

(C) *Tax benefit rule.* If an assignment or extinguishment of an intercompany obligation in an intercompany transaction is otherwise excepted from the definition of triggering transaction under paragraph (g)(3)(i)(B)(*1*), (*2*), (*5*), or (*6*) of this section (and not also under paragraph (g)(3)(i)(B)(*3*) or (*4*) of this section), and the assignment or extinguishment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit (as defined in paragraph (g)(2)(v) of this section) that the group or its members would not otherwise enjoy in a consolidated or separate return year, then the assignment or extinguishment will be a triggering transaction to which paragraph (g)(3)(ii) of this section applies.

(ii) *Application of deemed satisfaction and reissuance.* This paragraph (g)(3)(ii) applies if a triggering transaction occurs.

(A) *General rule.* If the intercompany obligation is debt of a member, then (except as provided in the following sentence) the debt is treated for all Federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to its fair market value, and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction. However, if the creditor realizes an amount with respect to the debt in the triggering transaction that differs from the debt's fair market value, and the triggering transaction is not an exchange (or deemed exchange) of debt of a member for newly issued debt of a member, then the debt is treated for all Federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to such amount realized, and reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction. If the triggering transaction is a mark to fair market value under section 475, then the intercompany obligation will be deemed satisfied and reissued for its fair market value (as determined under section 475 and applicable regulations) and section 475 will not otherwise apply with respect to that triggering transaction. If the intercompany obligation is a security of a member, similar principles apply (with appropriate adjustments) to treat the security as having been satisfied and reissued immediately before the triggering transaction.

(B) *Treatment as separate transaction.* The deemed satisfaction and deemed reissuance are treated as transactions separate and apart from the triggering transaction. The deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for Federal income tax purposes.

(4) *Special rules*—(i) *Timing and attributes.* For purposes of applying the matching rule and the acceleration rule to a transaction involving an intercompany obligation (other than a transaction to which paragraph (g)(5) of this section applies)—

(A) 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 the intercompany obligation pursuant to § 1.1502–36(d), or pursuant to sections 108 and 1017 and § 1.1502–28 or any other provision that adjusts the basis of an intercompany obligation as a substitute for income or gain;

(B) 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 the intercompany obligation from being excluded from gross income;

(C) Any income, gain, deduction, or loss from the intercompany obligation is not subject to section 108(a), section 354, section 355(a)(1), section 1091, or, in the case of an extinguishment of an intercompany obligation in a transaction in which the creditor transfers the obligation to the debtor in exchange for stock in such debtor, section 351(a); and

(D) Section 108(e)(7) does not apply upon the extinguishment of an intercompany obligation.

(ii) *Newly issued obligation in intercompany exchange.* If an intercompany obligation is exchanged (or is deemed exchanged) for a newly issued intercompany obligation and the exchange (or deemed exchange) is not a routine modification of an intercompany obligation (as described in paragraph (g)(3)(i)(B)(*6*) of this section), then the newly issued obligation will be treated for all Federal income tax purposes as having an issue price equal to its fair market value.

(iii) *Off-market issuance.* If an intercompany obligation is issued at a rate of interest that is materially off-market (off-market obligation) with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit (as defined in paragraph (g)(2)(v) of this section), then the intercompany obligation will be treated, for all Federal income tax purposes, as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor and the debtor at the time the obligation is issued. For example, if S lends $100 to B in return for an off-market B note valued at $130, and the note is issued with a view to shift items from the note to secure a tax benefit, then the B note will be treated as issued for $130. The $30 difference will be treated as a distribution or capital contribution between S and B (as appropriate) at the time of issuance, and this amount will be reflected in future payments on the note as bond issuance premium. An adjustment to an off-market obligation under this paragraph (g)(4)(iii) will be made without regard to the application of, and in lieu of any adjustment under, section 467 (certain payments for the use of property or services), 482 (allocations among commonly controlled taxpayers), 483 (interest on certain deferred payments), 1274 (determination of issue price for certain debt instruments issued for property), or 7872 (treatment of loans with below-market interest rates).

(iv) *Deferral of loss or deduction with respect to nonmember indebtedness acquired in certain debt exchanges.* If a creditor transfers an intercompany obligation to a nonmember (former intercompany obligation) in exchange for newly issued debt of a nonmember (nonmember debt), and the issue price of the nonmember debt is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law), then any loss of the creditor otherwise allowable on the subsequent disposition of the nonmember debt, or any comparable tax benefit that would otherwise be available in any other transaction that directly or indirectly results from the disposition of the nonmember debt, is deferred until the date the debtor retires the former intercompany obligation.

(v) *Bad debt reserve.* A member's deduction under section 585 for an addition to its reserve for bad debts with respect to an intercompany obligation is not taken into account, and is not treated as realized for purposes of paragraph (g)(3)(i)(A)(*1*) of this section, until the intercompany obligation is extinguished or becomes an obligation that is not an intercompany obligation.

(5) *Deemed satisfaction and reissuance of obligations becoming intercompany obligations*—(i) *Application of deemed satisfaction and reissuance*—(A) *In general.* This paragraph (g)(5) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(5) does not apply to an intercompany obligation if either of the following exceptions apply.

(*1*) *Exception to the application of section 108(e)(4).* The obligation becomes an intercompany obligation by reason of an event described in § 1.108–2(e)(2) (exception to the application of section 108(e)(4) in the case of acquisitions by securities dealers); or

(*2*) *Inbound subgroup exception.* The obligation becomes an intercompany obligation in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the intercompany obligation, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.

(ii) *Deemed satisfaction and reissuance*—(A) *General rule.* If the intercompany obligation is debt of a member, then the debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany obligation, as having been satisfied by the debtor for cash in an amount determined under the principles of § 1.108–2(f), and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash. If the intercompany obligation is a security of a member, similar principles apply (with appropriate adjustments) to treat the security, immediately after it becomes an intercompany obligation, as satisfied and reissued by the debtor for cash in an amount equal to its fair market value.

(B) *Treatment as separate transaction.* The deemed satisfaction and deemed reissuance are treated as transactions separate and apart from the transaction in which the debt becomes an intercompany obligation, and the tax consequences of the transaction in which the debt becomes an intercompany obligation must be determined before the deemed satisfaction and reissuance occurs. (For example, if the debt becomes an intercompany obligation in a transaction to which section 351 applies, any limitation imposed by section 362(e) on the basis of the intercompany obligation in the hands of the transferee member is determined before the deemed satisfaction and reissuance.) The deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for Federal income tax purposes.

(6) *Special rules*—(i) *Timing and attributes.* If paragraph (g)(5) of this section applies to an intercompany obligation—

(A) Section 108(e)(4) does not apply;

(B) The attributes of all items taken into account from the satisfaction of the intercompany obligation are determined on a separate entity basis, rather than by treating S and B as divisions of a single corporation; and

(C) Any intercompany gain or loss realized by the creditor is not subject to section 354 or section 1091.

(ii) *Waiver of loss carryovers from separate return limitation years.* Solely for purposes of § 1.1502–32(b)(4) and the effect of any election under that provision, any loss taken into account under paragraph (g)(5) of this section by a corporation that becomes a member as a result of the transaction in which the obligation becomes an intercompany obligation is treated as a loss carryover from a separate return limitation year.

(iii) *Deduction of repurchase premium in certain debt exchanges.* If an obligation to which paragraph (g)(5) of this section applies is acquired in exchange for the issuance of an obligation to a nonmember and the issue price of this newly issued obligation is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law), then, under the principles of § 1.163–7(c), any repurchase premium from the deemed satisfaction of the intercompany obligation under paragraph (g)(5)(ii) of this section will be amortized by the debtor over the term of the obligation issued to the nonmember in the same manner as if it were original issue discount and the obligation to the nonmember had been issued directly by the debtor.

(7) *Examples*—(i) *In general.* For purposes of the examples in this paragraph (g), unless otherwise stated, interest is qualified stated interest under § 1.1273–1(c), and the intercompany obligations are capital assets and are not subject to section 475.

(ii) The application of this section to obligations of members is illustrated by the following examples:

Example 1. Interest on intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a $10 interest deduction annually under section 163, and S accrues $10 of interest income annually under section 61(a)(4) and § 1.446–2.

(ii) *Matching rule.* Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its $10 of income into account in each of years 1 through 5 to reflect the $10 difference between B's $10 of interest expense taken into account and the $0 recomputed expense. S's income and B's deduction are ordinary items. (Because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.)

(iii) *Original issue discount.* The facts are the same as in paragraph (i) of this *Example 1,* except that B borrows $90 (rather than $100) from S in return for B's note providing for $10 of interest annually and repayment of $100 at the end of year 5. The principles described in paragraph (ii) of this *Example 1* for stated interest also apply to the $10 of original issue discount. Thus, as B takes into account its corresponding expense under section 163(e), S takes into account its intercompany income under section 1272. S's income and B's deduction are ordinary items.

(iv) *Tax-exempt income.* The facts are the same as in paragraph (i) of this *Example 1,* except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies. The timing of S's income is the same as in paragraph (ii) of this *Example 1.* Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item of disallowed interest expense control the attributes of S's offsetting intercompany interest income. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income because section 265(a)(2) permanently and explicitly disallows B's corresponding deduction and because, under paragraph (g)(4)(i)(B) of this section, paragraph (c)(6)(ii) of this section does not apply to prevent any intercompany income from the B note from being excluded from gross income. Accordingly, S's intercompany income is treated as excluded from gross income.

Example 2. Intercompany obligation becomes nonintercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has paid the interest accruing under the note and S sells B's note to X for $70, reflecting an increase in prevailing market interest rates. B is never insolvent within the meaning of section 108(d)(3).

(ii) *Deemed satisfaction and reissuance.* Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $70 immediately before S's sale to X. As a result of the deemed satisfaction of the note for less than its adjusted issue price, B takes into account $30 of discharge of indebtedness income under § 1.61–12. On a separate entity basis, S's $30 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's $30 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $70 issue price, a $100 stated redemption price at maturity, and a $70 basis in the hands of S. S is then treated as selling the new note to X for the $70 received by S in the actual transaction. Because S has a basis of $70 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new note held by X is not an intercompany obligation, it has a $70 issue price, a $100 stated redemption price at maturity, and a $70 basis. The $30 of original issue discount will be taken into account by B and X under sections 163(e) and 1272.

(iii) *Creditor deconsolidation.* The facts are the same as in paragraph (i) of this *Example 2*, except that P sells S's stock to X (rather than S selling B's note to X). Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its $70 fair market value immediately before S becomes a nonmember. The treatment of S's $30 of loss and B's $30 of discharge of indebtedness income is the same as in paragraph (ii) of this *Example 2.* The new note held by S upon deconsolidation is not an intercompany obligation, it has a $70 issue price, a $100 stated redemption price at maturity, and a $70 basis. The $30 of original issue discount will be taken into account by B and S under sections 163(e) and 1272.

(iv) *Debtor deconsolidation.* The facts are the same as in paragraph (i) of this *Example 2,* except that P sells B's stock to X (rather than S selling B's note to X). The results to S and B are the same as in paragraph (iii) of this *Example 2.*

(v) *Subgroup exception.* The facts are the same as in paragraph (i) of this *Example 2,* except that P owns all of the stock of S, S owns all of the stock of B, and P sells all of the S stock to X, the parent of another consolidated group. Because B and S, members of an intercompany obligation subgroup, cease to be members of the P group in a transaction that does not cause either member to recognize an item with respect to the B note, and such members constitute an intercompany obligation subgroup in the X group, P's sale of S stock is not a triggering transaction under paragraph (g)(3)(i)(B)(*8*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. After the sale, the note held by S has a $100 issue price, a $100 stated redemption price at maturity, and a $100 basis. The results are the same if the S stock is sold to an individual and the S–B affiliated group elects to file a consolidated return for the period beginning on the day after S and B cease to be members of the P group.

(vi) *Section 338 election.* The facts are the same as paragraph (i) of this *Example 2,* except that P sells S's stock to X and a section 338 election is made with respect to the stock sale. Under section 338, S is treated as selling all of its assets to new S, including the B note, at the close of the acquisition date. The aggregate deemed sales price (within the meaning of § 1.338–4) allocated to the B note is $70. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued immediately before S's deemed sale to new S for $70, the amount realized with respect to the note (the aggregate deemed sales price allocated to the note under § 1.338–6). The results to S and B are the same as in paragraph (ii) of this *Example 2.*

(vii) *Appreciated note.* The facts are the same as in paragraph (i) of this *Example 2,* except that S sells B's note to X for $130 (rather than $70), reflecting a decline in prevailing market interest rates. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $130 immediately before S's sale to X. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $130 issue price, $100 stated redemption price at maturity, and $130 basis in the hands of S. S is then treated as selling the new note to X for the $130 received by S in the actual transaction. Because S has a basis of $130 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new note held by X is not an intercompany obligation, it has a $130 issue price, a $100 stated redemption price at maturity, and a $130 basis. The treatment of B's $30 of bond issuance premium under the new note is determined under § 1.163–13.

(viii) *Deferral of loss or deduction with respect to nonmember indebtedness acquired in debt exchange.* The facts are the same as in paragraph (i) of this *Example 2*, except that S sells B's note to X for a non-publicly traded X note with an issue price and face amount of $100 and a fair market value of $70, and that, subsequently, S sells the X note for $70. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued immediately before S's sale to X for $100, the amount realized with respect to the note (determined under section 1274). As a result of the deemed satisfaction, neither S nor B take into account any items of income, gain, deduction, or loss. S is then treated as selling the new B note to X for the X note received by S in the actual transaction. Because S has a basis of $100 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new B note held by X is not an intercompany obligation, it has a $100 issue price, a $100 stated redemption price at maturity, and a $100 basis. S also holds an X note with a basis of $100 but a fair market value of $70. When S disposes of the X note, S's loss on the disposition is deferred under paragraph (g)(4)(iv) of this section, until B retires its note (the former intercompany obligation in the hands of X).

Example 3. Loss or bad debt deduction with respect to intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. On January 1 of year 3, the fair market value of the B note has declined to $60 and S sells the B note to P for property with a fair market value of $60. B is never insolvent within the meaning of section 108(d)(3). The B note is not a security within the meaning of section 165(g)(2).

(ii) *Deemed satisfaction and reissuance.* Because S realizes an amount of loss from the assignment of the B note, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $60 immediately before S's sale to P. As a result of the deemed satisfaction of the note for less than its adjusted issue price ($100), B takes into account $40 of discharge of indebtedness income under § 1.61–12. On a separate entity basis, S's $40 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's $40 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $60 issue price, $100 stated redemption price at maturity, and $60 basis in the hands of S. S is then treated as selling the new note to P for the $60 of property received by S in the actual transaction. Because S has a basis of $60 in the new note, S recognizes no gain or loss from the sale to P. After the sale, the note is an intercompany obligation, it has a $60 issue price and a $100 stated redemption price at maturity, and the $40 of original issue discount will be taken into account by B and P under sections 163(e) and 1272.

(iii) *Partial bad debt deduction.* The facts are the same as in paragraph (i) of this *Example 3*, except that S claims a $40 partial bad debt deduction under section 166(a)(2) (rather than selling the note to P). Because S realizes a deduction from a transaction comparable to an assignment of the B note, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $60 immediately before section 166(a)(2) applies. The treatment of S's $40 loss and B's $40 of discharge of indebtedness income are the same as in paragraph (ii) of this *Example 3.* After the reissuance, S has a basis of $60 in the new note. Accordingly, the application of section 166(a)(2) does not result in any additional deduction for S. The $40 of original issue discount on the new note will be taken into account by B and S under sections 163(e) and 1272.

(iv) *Insolvent debtor.* The facts are the same as in paragraph (i) of this *Example 3,* except that B is insolvent within the meaning of section 108(d)(3) at the time that S sells the note to P. As explained in paragraph (ii) of this *Example 3,* the transaction is a triggering transaction and the B note is treated as satisfied and reissued for its fair market value of $60 immediately before S's sale to P. On a separate entity basis, S's $40 loss would be capital, B's $40 income would be excluded from gross income under section 108(a), and B would reduce attributes under section 108(b) or section 1017 (see also § 1.1502–28). However, under paragraph (g)(4)(i)(C) of this section, section 108(a) does not apply to characterize B's income as excluded from gross income. Accordingly, the attributes of S's loss and B's income are redetermined in the same manner as in paragraph (ii) of this *Example 3.*

Example 4. Intercompany nonrecognition transactions. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is $130, reflecting a decline in prevailing market interest rates. On January 1 of year 3, S transfers the note and other assets to a newly formed corporation, Newco, for all of Newco's common stock in an exchange to which section 351 applies.

(ii) *No deemed satisfaction and reissuance.* Because the assignment of the B note is an exchange to which section 351 applies and S recognizes no gain or loss, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*1*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

(iii) *Receipt of other property.* The facts are the same as in paragraph (i) of this *Example 4,* except that the other assets transferred to Newco have a basis of $100 and a fair market value of $260, and S receives, in addition to Newco common stock, $15 of cash. Because S would recognize $15 of gain under section 351(b), the assignment of the B note is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $130 immediately before the transfer to Newco. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $130 issue price, $100 stated redemption price at maturity, and $130 basis in the hands of S. S is then treated as transferring the new note to Newco for the Newco stock and cash received by S in the actual transaction. Because S has a basis of $130 in the new B note, S recognizes no gain or loss with respect to the transfer of the note in the section 351 exchange, and S recognizes $10 of gain with respect to the transfer of the other assets under section 351(b). After the transfer, the note has a $130 issue price and a $100 stated redemption price at maturity. The treatment of B's $30 of bond issuance premium under the new note is determined under § 1.163–13.

(iv) The facts are the same as in paragraph (i) of this *Example 4,* except that T is a member with a loss from a separate return limitation year that is subject to limitation under § 1.1502–21(c) (a SRLY loss), and on January 1 of year 3, S transfers the assets and the B note to T in an exchange to which section 351 applies. Because the transferee, T, has a loss that is subject to a limitation, the assignment of the B note is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section (the exception in paragraph (g)(3)(i)(B)(*1*) of this section does not apply). Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value, immediately before S's transfer to T. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $130 issue price, $100 stated redemption price at maturity, and $130 basis in the hands of S. The treatment of B's $30 of bond issuance premium under the new note is determined under § 1.163–13. S is then treated as transferring the new note to T as part of the section 351 exchange. Because T will have a fair market value basis in the reissued B note immediately after the exchange, T's intercompany item from the subsequent retirement of the B note will not reflect any of S's built-in gain (and the amount of T's SRLY loss that may be absorbed by such item will be limited to any appreciation in the B note accruing after the exchange).

(v) *Intercompany obligation transferred in section 332 transaction.* The facts are the same as in paragraph (i) of this *Example 4,* except that S transfers the B note to P in complete liquidation under section 332. Because the transaction is an exchange to which section 332 and section 337(a) applies, and neither S nor B recognize gain or loss, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*1*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

Example 5. Assumption of intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. The note is fully recourse and is incurred for use in Business Z. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is $110 reflecting a decline in prevailing market interest rates. Business Z has a fair market value of $95. On January 1 of year 3, B transfers all of the assets of Business Z and $15 of cash (substantially all of B's assets) to member T in exchange for the assumption by T of all of B's obligations under the note in a transaction in which gain or loss is recognized under section 1001. The terms and conditions of the note are not modified in connection with the sales transaction, the transaction does not result in a change in payment expectations, and no amount of income, gain, loss, or deduction is recognized by S, B, or T with respect to the note.

(ii) *No deemed satisfaction and reissuance.* Because all of B's obligations under the B note are assumed by T in connection with the sale of the Business Z assets, the assignment of B's obligations under the note is not a triggering transaction under paragraph (g)(3)(i)(B)(*2*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

Example 6. Extinguishment of intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 20. The note is a security within the meaning of section 351(d)(2). As of January 1 of year 3, B has fully performed its obligations, but the fair market value of the B note is $130, reflecting a decline in prevailing market interest rates, and S transfers the note to B in exchange for $130 of B stock in a transaction to which both section 351 and section 354 applies.

(ii) *No deemed satisfaction and reissuance.* As a result of the satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). Although the transfer of the B note is a transaction to which both section 351 and section 354 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to either section 351(a) or section 354, and therefore, S has a $30 gain under section 1001. Because the note is extinguished in a transaction in which the adjusted issue price of the note is equal to the creditor's basis in the note, and the debtor's and creditor's items offset in amount, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*5*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. Under paragraph (g)(4)(i)(D) of this section, section 108(e)(7) does not apply upon the extinguishment of the B note, and therefore, the B stock received by S in the exchange will not be treated as section 1245 property.

Example 7. Exchange of intercompany obligations. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 20. As of January 1 of year 3, B has fully performed its obligations and, pursuant to a recapitalization to which section 368(a)(1)(E) applies, B issues a new note to S in exchange for the original B note. The new B note has an issue price, stated redemption price at maturity, and stated principal amount of $100, but contains terms that differ sufficiently from the terms of the original B note to cause a realization event under § 1.1001–3. The original B note and the new B note are both securities (within the meaning of section 354(a)(1)).

(ii) *No deemed satisfaction and reissuance.* Because the original B note is extinguished in exchange for a newly issued B note and the issue price of the new B note is equal to both the adjusted issue price of the original B note and S's basis in the original B note, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*6*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. B has neither income from discharge of indebtedness under section 108(e)(10) nor a deduction for repurchase premium under § 1.163–7(c). Although the exchange of the original B note for the new B note is a transaction to which section 354 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to section 354. Under section 1001, S has no gain or loss from the exchange of notes.

Example 8. Tax benefit rule. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value has depreciated, reflecting an increase in prevailing market interest rates. On that date, S transfers the B note to member T as part of an exchange for T common stock which is intended to qualify for nonrecognition treatment under section 351 but with a view to sell the T stock at a reduced gain. On February 1 of year 4, all of the stock of T is sold at a reduced gain.

(ii) *Deemed satisfaction and reissuance.* Because the assignment of the B note does not occur within 12 months of the sale of T stock, paragraph (g)(3)(i)(B)(*1*)(*vi*) of this section does not apply to treat the assignment as a triggering transaction. However, because the assignment of the B note was engaged in with a view to shift built-in loss from the obligation in order to secure a tax benefit that the group or its members would not otherwise enjoy, under paragraph (g)(3)(i)(C) of this section, the assignment of the B note is a triggering transaction to which paragraph (g)(3)(ii) of this section applies. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value, immediately before S's transfer to T. As a result of the deemed satisfaction of the note for less than its adjusted issue price, B takes into account discharge of indebtedness income and S has a corresponding loss which is treated as ordinary loss. B is also treated as reissuing, immediately after the deemed satisfaction, a new note to S with an issue price and basis equal to its fair market value. S is then treated as transferring the new note to T as part of the section 351 exchange. Because S's basis in the T stock received with respect to the transferred B note is equal to its fair market value, S's gain with respect to the T stock will not reflect any of the built-in loss attributable to the B note. (This example does not address common law doctrines or other authorities that might apply to recharacterize the transaction or to otherwise affect the tax treatment of the transaction.)

Example 9. Issuance at off-market rate of interest. (i) *Facts.* T is a member with a SRLY loss. T's sole shareholder, P, borrows an amount of cash from T in return for a P note that provides for a materially above market rate of interest. The P note is issued with a view to generate additional interest income to T over the term of the note to facilitate the absorption of T's SRLY loss.

(ii) *With a view.* Because the P note is issued with a view to shift interest income from the off-market obligation in order to secure a tax benefit that the group or its members would not otherwise enjoy, under paragraph (g)(4)(iii) of this section, the intercompany obligation is treated, for all Federal income tax purposes, as originally issued for its fair market value so T is treated as purchasing the note at a premium. The difference between the amount loaned and the fair market value of the obligation is treated as transferred from P to T as a capital contribution at the time the note is issued. Throughout the term of the note, T takes into account interest income and bond premium and P takes into account interest deduction and bond issuance premium under generally applicable Internal Revenue Code sections. The adjustment under paragraph (g)(4)(iii) of this section is made without regard to the application of, and in lieu of any adjustment under, section 482 or 1274.

Example 10. Nonintercompany obligation becomes intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from X in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is $70, reflecting an increase in prevailing market interest rates. On January 1 of year 3, P buys all of X's stock. B is solvent within the meaning of section 108(d)(3).

(ii) *Deemed satisfaction and reissuance.* Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for $70 (determined under the principles of § 1.108–2(f)(2)) immediately after it becomes an intercompany obligation. Both X's $30 capital loss (under section 1271(a)(1)) and B's $30 of discharge of indebtedness income (under § 1.61–12) are taken into account in determining consolidated taxable income for year 3. Under paragraph (g)(6)(i)(B) of this section, the attributes of items resulting from the satisfaction are determined on a separate entity basis. But see section 382 and § 1.1502–15 (as appropriate). B is also treated as reissuing a new note to X. The new note is an intercompany obligation, it has a $70 issue price and $100 stated redemption price at maturity, and the $30 of original issue discount will be taken into account by B and X in the same manner as provided in paragraph (iii) of *Example 1* of this paragraph (g)(7).

(iii) *Amortization of repurchase premium.* The facts are the same as in paragraph (i) of this *Example 10,* except that on January 1 of year 3, the B note has a fair market value of $130 and rather than P purchasing the X stock, P purchases the B note from X by issuing its own note. The P note has an issue price, stated redemption price at maturity, stated principal amount, and fair market value of $130. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for $130 (determined under the principles of § 1.108–2(f)(1)) immediately after it becomes an intercompany obligation. As a result of the deemed satisfaction of the note, P has no gain or loss and B has $30 of repurchase premium. Under paragraph (g)(6)(iii) of this section, B's $30 of repurchase premium from the deemed satisfaction is amortized by B over the term of the newly issued P note in the same manner as if it were original issue discount and the newly issued P note had been issued directly by B. B is also treated as reissuing a new note to P. The new note is an intercompany obligation, it has a $130 issue price and $100 stated redemption price at maturity, and the treatment of B's $30 of bond issuance premium under the new B note is determined under § 1.163–13.

(iv) *Election to file consolidated returns.* Assume instead that B borrows $100 from S during year 1, but the P group does not file consolidated returns until year 3. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied and reissued as a new note immediately after the note becomes an intercompany obligation. The satisfaction and reissuance are deemed to occur on January 1 of year 3, for the fair market value of the obligation (determined under the principles of § 1.108–2(f)(2)) at that time.

Example 11. Notional principal contracts. (i) *Facts.* On April 1 of year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined by reference to LIBOR on the day each payment is due, multiplied by a $1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in year 2, in an amount equal to 8 percent multiplied by the same notional principal amount. LIBOR is 7.80 percent on April 1 of year 2, and therefore, M2 owes $2 to M1.

(ii) *Matching rule.* Under § 1.446–3(d), the net income (or net deduction) from a notional principal contract for a taxable year is included in (or deducted from) gross income. Under § 1.446–3(e), the ratable daily portion of M2's obligation to M1 as of December 31 of year 1 is $1.50 ($2 multiplied by 275/365). Under the matching rule, M1's net income for year 1 of $1.50 is taken into account to reflect the difference between M2's net deduction of $1.50 taken into account and the $0 recomputed net deduction. Similarly, the $.50 balance of the $2 of net periodic payments made on April 1 of year 2 is taken into account for year 2 in M1's and M2's net income and net deduction from the contract. In addition, the attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. (Although M1 is the selling member with respect to the payment on April 1 of year 2, it might be the buying member in a subsequent period if it owes the net payment.)

(iii) *Dealer.* The facts are the same as in paragraph (i) of this *Example 11,* except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to fair market value at year-end. Assume that under section 475, M2's loss from marking to fair market value the contract with M1 is $10. Because M2 realizes an amount of loss from the mark to fair market value of the contract, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, M2 is treated as making a $10 payment to M1 to terminate the contract immediately before a new contract is treated as reissued with an up-front payment by M1 to M2 of $10. M1's $10 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under § 1.446–3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Under § 1.446–3(f), the deemed $10 up-front payment by M1 to M2 in connection with the issuance of a new contract is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the $1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment from M2 might be ordinary or capital). Under paragraph (g)(3)(ii)(A) of this section, section 475 does not apply to mark the notional principal contract to fair market value after its deemed satisfaction and reissuance.

(8) *Effective/applicability date.* The rules of this paragraph (g) apply to transactions involving intercompany obligations occurring in consolidated return years beginning on or after December 24, 2008.

* * * * *

■ **Par. 3.** Section 1.1502–28 is amended by:

■ 1. Revising paragraph (b)(5)(i).

■ 2. Revising the last sentence of paragraph (b)(5)(ii).

■ 3. Adding a sentence to the end of paragraph (d).

The revisions and addition reads as follows:

§ 1.1502–28 Consolidated section 108.

* * * * *

(b) * * *

(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 creditor becomes a nonmember, or because the assets of the debtor or the creditor are acquired by a nonmember in a transaction to which section 381 applies, then the basis of such intercompany obligation (or new obligation if the intercompany obligation is deemed reissued 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) * * * See § 1.1502–13(g)(3)(i)(A)(*1*) and (g)(4)(i)(A).

* * * * *

(d) * * * Paragraph (b)(5)(i) of this section and the last sentence of paragraph (b)(5)(ii) of this section applies to transactions occurring in consolidated return years beginning on or after December 24, 2008.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2008.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. E8–30718 Filed 12–24–08; 8:45 am]

BILLING CODE 4810–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9438]

RIN 1545–BI50

Guidance Regarding Foreign Base Company Sales Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance relating to foreign base company sales income in cases in which personal property sold by a controlled foreign corporation is manufactured,