

INTERNAL REVENUE BULLETIN



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

REG-102656-15, page 1005.

Proposed regulations under section 446 of the Code provide that, subject to certain exceptions (including the full margin exception), a notional principal contract with a nonperiodic payment must be treated as two separate transactions consisting of one or more loans and an on-market, level payment swap. The proposed regulations also provide an exception under section 956 of the Code from the definition of United States property for certain obligations of United States persons arising from upfront payments made with respect to notional principal contracts that qualify for the full margin exception under section 446. These regulations also withdraw the notice of proposed rulemaking (REG-107548-11; RIN 1545-BK10) published in the Federal Register on May 11, 2012 (77 FR 27669).

REG-107595-11, page 986.

This document contains proposed regulations that provide guidance regarding the application of the modified carryover basis rules of section 1022 of the Internal Revenue Code. Specifically, the proposed regulations will modify provisions of the Treasury Regulations involving basis rules by including a reference to section 1022 where appropriate. The regulations will affect property transferred from certain decedents who died in 2010. The regulations reflect changes to the law made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

REG-132634-14, page 997.

This document contains proposed regulations under section 7704(d)(1)(E) of the Internal Revenue Code relating to qualifying income from exploration, development, mining or production, processing, refining, transportation, and marketing of

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minerals or natural resources. The proposed regulations affect publicly traded partnerships and their partners.

Rev. Rul. 2015-9, page 972.

This ruling holds that the transaction described is properly treated for federal income tax purposes as a transfer of stock in an exchange governed by § 351 of the Internal Revenue Code (Code) followed by reorganizations under § 368(a)(1)(D) of the Code. Rev. Rul. 78-130, 1978-1 C.B. 114 is revoked.

Rev. Rul. 2015-10, page 973.

This ruling holds that the transaction described is properly treated for federal income tax purposes as two transfers of stock in exchanges governed by § 351 of the Internal Revenue Code (Code) followed by a reorganization under § 368(a)(1)(D) of the Code.

Rev. Rul. 2015-11, page 975.

The revenue ruling holds that the cost of unrecoverable precious metals used in various manufacturing processes are depreciable under §§ 167 and 168 of the Internal Revenue Code. The costs of any recoverable precious metals are not depreciable.

T.D. 9719, page 977.

Final, temporary and proposed regulations under section 446 of the Code provide that, subject to certain exceptions (including the full margin exception), a notional principal contract with a nonperiodic payment must be treated as two separate transactions consisting of one or more loans and an on-market, level payment swap. These regulations also provide an exception under section 956 of the Code from the definition of United States property for certain obligations of United States persons arising from upfront payments made with respect to notional principal contracts that qualify for the full margin exception under section 446.

(Continued on the next page)

EMPLOYEE PLANS

REG-107595-11, page 986.

This document contains proposed regulations that provide guidance regarding the application of the modified carryover basis rules of section 1022 of the Internal Revenue Code. Specifically, the proposed regulations will modify provisions of the Treasury Regulations involving basis rules by including a reference to section 1022 where appropriate. The regulations will affect property transferred from certain decedents who died in 2010. The regulations reflect changes to the law made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

ESTATE TAX

REG-107595-11, page 986.

This document contains proposed regulations that provide guidance regarding the application of the modified carryover basis rules of section 1022 of the Internal Revenue Code. Specifically, the proposed regulations will modify provisions of the Treasury Regulations involving basis rules by including a reference to section 1022 where appropriate. The regulations will affect property transferred from certain decedents who died in 2010. The regulations reflect changes to the law made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

GIFT TAX

REG-107595-11, page 986.

This document contains proposed regulations that provide guidance regarding the application of the modified carryover basis rules of section 1022 of the Internal Revenue Code. Specifically, the proposed regulations will modify provisions of the Treasury Regulations involving basis rules by including a reference to section 1022 where appropriate. The regulations will affect property transferred from certain decedents who died in 2010. The regulations reflect changes to the law made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

ADMINISTRATIVE

Notice 2015-38, page 984.

This Notice updates the list of designated private delivery service ("designated PDSs") set forth in Notice 2004-83, 2004-2 C.B. 1030, for purposes of the timely mailing treated as timely filing/paying rule of section 7502 of the Internal Revenue Code, providing rules for determining the postmark date for these services, and provides a new address for submitting documents to the Internal Revenue Service ("IRS") with respect to an application for designation as a designated PDS.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the 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.

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.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-2: Definition of terms.
(Also §§ 351, 7805; 1.351-1, 301.7805-1.)

Rev. Rul. 2015-9

ISSUE

Is a transaction in which (1) a domestic corporation transfers all of the stock of its foreign operating subsidiary to its foreign holding company subsidiary in exchange for additional stock, (2) the foreign operating subsidiary and three foreign subsidiaries of the foreign holding company transfer substantially all of their assets to a newly-formed foreign subsidiary of the foreign holding company in exchange for stock of the new subsidiary, and (3) the subsidiaries that transfer their assets are liquidated, properly treated for federal income tax purposes as a transfer of the foreign operating subsidiary's stock in an exchange governed by § 351 of the Internal Revenue Code (Code) followed by reorganizations under § 368(a)(1)(D) of the Code?

FACTS

P, a domestic corporation, owns all of the stock of *S-1* and *S-2*, both of which are incorporated in foreign country *R*. *S-1* is an operating company. *S-2* is a holding company that owns all of the stock of *X*, *Y*, and *Z*, which are operating companies incorporated in foreign country *R*.

All of the operating companies in country *R* are to be combined into a new subsidiary of *S-2* to be formed in country *R* in accordance with the following plan:

- (a) *S-2* will organize *N* corporation, in foreign country *R*, solely for the purpose of participating in the proposed transaction.
- (b) *P* will then transfer all of the stock of *S-1* to *S-2* in exchange for additional shares of voting common stock of *S-2* (*P*'s transfer).

(c) Immediately after *P*'s transfer, *X*, *Y*, and *Z*, as well as *S-1*, will transfer substantially all of their assets (subject to liabilities) to *N*, in exchange for additional shares of common stock of *N* (*X*, *Y*, and *Z*'s transfers and *S-1*'s transfer).

(d) *X*, *Y*, *Z*, and *S-1* will liquidate and distribute all of their *N* stock to *S-2* (*X*, *Y*, and *Z*'s liquidations and *S-1*'s liquidation).

Following the transaction, *N* will continue to conduct the businesses formerly conducted by *S-1*, *X*, *Y*, and *Z*.

To avoid recognizing gain under § 367(a)(1) and § 1.367(a)-3(a) on the transfer of the *S-1* stock to *S-2*, *P* will properly enter into a gain recognition agreement pursuant to § 1.367(a)-8 with respect to that transfer and will satisfy the applicable exceptions to triggering events resulting from the other exchanges that occur in the transaction. *P* will also take into account the application of § 1.367(b)-4, which may require shareholders that exchange stock of a foreign corporation in certain nonrecognition exchanges (including §§ 351 and 354) to include in income as a deemed dividend the § 1248 amount attributable to the exchanged stock.

LAW

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 368(c) defines "control" to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 368(a)(1)(D) provides that the term "reorganization" includes a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including

persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, 355, or 356.

Section 354(a) provides, in general, that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 368(b)(2) provides that "a party to a reorganization" includes both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or property of the other.

Section 354(b)(1) provides, in general, that § 354(a) will not apply to an exchange in pursuance of a plan of reorganization under § 368(a)(1)(D) unless (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 368(a)(2)(H) provides that for purposes of determining whether a nondivisive transaction qualifies under § 368(a)(1)(D), the term "control" has the meaning given such term by § 304(c).

Section 304(c)(1) provides that "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation, which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation or owns at least 50 percent of the total value

of the shares of all classes of stock of another corporation, then such person (or persons) will be treated as in control of such other corporation.

ANALYSIS

A transfer of property may be respected as a § 351 exchange even if it is followed by subsequent transfers of the property as part of a prearranged, integrated plan. *See* Rev. Rul. 77-449, 1977-2 C.B. 110, *amplified by* Rev. Rul. 83-34, 1983-1 C.B. 79, and Rev. Rul. 83-156, 1983-2 C.B. 66; *see also* Rev. Rul. 2003-51, 2003-1 C.B. 938. However, a transfer of property in an exchange otherwise described in § 351 will not qualify as a § 351 exchange if, for example, a different treatment is warranted to reflect the substance of the transaction as a whole. *See* Rev. Rul. 54-96, 1954-1 C.B. 111; Rev. Rul. 70-140, 1970-1 C.B. 73; *see also* Rev. Rul. 2015-10, page 973, this Bulletin (holding that the transfer by a corporation to its wholly-owned subsidiary of all of the interests in an entity classified as a corporation for federal income tax purposes, followed by the entity's planned election to be disregarded as separate from its owner for federal income tax purposes, is more properly characterized as a § 368(a)(1)(D) reorganization than as a § 351 transfer followed by a § 332 liquidation).

Under the facts of this revenue ruling, *P*'s transfer satisfies the formal requirements of § 351, including the requirement that *P* control *S-2* within the meaning of § 368(c) immediately after the exchange. Moreover, even though *P*'s transfer and *S-1*'s transfer and liquidation are steps in a prearranged, integrated plan that has as its objective the consolidation of *S-1* and the other operating companies in *N*, an analysis of the transaction as a whole does not dictate that *P*'s transfer be treated other than in accordance with its form in order to reflect the substance of the transaction. Accordingly, *P*'s transfer is respected as a § 351 exchange, and no gain or loss is recognized by *P* on the transfer of all of the stock of *S-1* to *S-2*.

S-1's transfer followed by *S-1*'s liquidation is a reorganization under § 368(a)(1)(D). *X*, *Y*, and *Z*'s transfers followed by *X*, *Y*, and *Z*'s liquidations are also reorganizations under § 368(a)(1)(D).

HOLDING

A transaction in which (1) a domestic corporation transfers all of the stock of its foreign operating subsidiary to its foreign holding company subsidiary in exchange for additional stock, (2) the foreign operating subsidiary and three foreign subsidiaries of the foreign holding company transfer substantially all of their assets to a newly-formed foreign subsidiary of the foreign holding company in exchange for stock of the new subsidiary, and (3) the subsidiaries that transfer their assets are liquidated, is properly treated for federal income tax purposes as a transfer of the foreign operating subsidiary's stock in an exchange governed by § 351 followed by reorganizations under § 368(a)(1)(D).

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 78-130, 1978-1 C.B. 114 is revoked.

PROSPECTIVE APPLICATION

Under the authority of § 7805(b)(8), the Internal Revenue Service will not apply this revenue ruling to challenge a position taken by a taxpayer that reasonably relied on the conclusions in Rev. Rul. 78-130 prior to May 5, 2015 with respect to a transaction that occurs on or before such date, or a transaction that is effected pursuant to a written agreement (subject to customary conditions) that is binding on May 5, 2015 and at all times thereafter until the date the transaction is completed, provided that none of the purported acquiring corporation, issuing corporation, and transferor corporation (and each of their shareholders) treated the transaction inconsistently for federal income tax purposes. *See* § 601.601(d)(2)(v)(c) of the Statement of Procedural Rules.

DRAFTING INFORMATION

The principal author of this revenue ruling is Stephanie D. Floyd of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Stephanie D. Floyd at (202) 317-6848 (not a toll-free number).

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-2: Definition of terms. (Also §§ 351; 1.351-1, 301.7701-3.)

Rev. Rul. 2015-10

ISSUE

Is a transaction in which (1) a parent corporation transfers all of the interests in its limited liability company that is taxable as a corporation to its subsidiary (first subsidiary) in exchange for additional stock, (2) the first subsidiary transfers all of the interests in the limited liability company to its subsidiary (second subsidiary) in exchange for additional stock, (3) the second subsidiary transfers all of the interests in the limited liability company to its subsidiary (third subsidiary) in exchange for additional stock, and (4) the limited liability company elects to be disregarded as an entity separate from its owner for federal income tax purposes effective after it is owned by the third subsidiary, properly treated for federal income tax purposes as two transfers of stock in exchanges governed by § 351 of the Internal Revenue Code (Code) followed by a reorganization under § 368(a)(1)(D) of the Code?

FACTS

P, a domestic corporation, owns all of the interests in *LLC*, a domestic limited liability company that elected pursuant to § 301.7701-3(c) of the Procedure and Administration Regulations to be an association taxable as a corporation for federal income tax purposes effective on its date of formation. *P* also owns all of the stock of *S1*. *S1* owns all of the stock of *S2*, which owns all of the stock of *S3*. *S3* owns all of the stock of *S4*. *S1*, *S2*, and *S3* are each holding companies that are domestic corporations. For valid business purposes, and as part of a plan:

- (a) *P* will transfer all of the interests in *LLC* to *S1* in exchange for additional shares of voting common stock of *S1* (*P*'s transfer).
- (b) *S1* will transfer all of the interests in *LLC* to *S2* in exchange for ad-

ditional shares of voting common stock of *S2* (*S1*'s transfer).

(c) *S2* will transfer all of the interests in *LLC* to *S3* in exchange for additional shares of voting common stock of *S3* (*S2*'s transfer).

(d) *LLC* will elect pursuant to § 301.7701-3(c) to be disregarded as an entity separate from its owner for federal income tax purposes, effective no sooner than one day after *S2*'s transfer (*LLC*'s election).

Following the transaction, *S3* will, through *LLC*, continue to conduct the business conducted by *LLC* prior to the transaction.

LAW

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 368(c) defines "control" to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (eligible entity) can elect its classification for federal income tax purposes. An eligible entity with at least two members can elect pursuant to § 301.7701-3(c) to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(g)(1)(iii) provides that if an eligible entity classified as an association elects pursuant to § 301.7701-3(c) to be disregarded as an entity separate from its owner, the following is deemed to occur: the association distributes all of its assets and liabilities to its single owner in liquidation of the association.

Section 301.7701-3(g)(2)(i) provides that the tax treatment of a change in the

classification of an entity for federal income tax purposes by an election pursuant to § 301.7701-3(c) is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 368(a)(1)(D) provides that the term "reorganization" includes a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, 355, or 356.

Section 354(a) provides, in general, that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 368(b)(2) provides that "a party to a reorganization" includes both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or property of the other.

Section 354(b)(1) provides, in general, that § 354(a) will not apply to an exchange in pursuance of a plan of reorganization under § 368(a)(1)(D) unless (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 368(a)(2)(H) provides that for purposes of determining whether a nondivisive transaction qualifies under § 368(a)(1)(D), the term "control" has the meaning given such term by § 304(c).

Section 304(c)(1) provides that "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all

classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation, which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) will be treated as in control of such other corporation.

Section 304(c)(3) provides, in part, that § 318(a) relating to constructive ownership of stock will apply for purposes of determining control under § 304 and that paragraph (2)(C) of § 318(a) will be applied by substituting "5 percent" for "50 percent."

As modified by § 304(c)(3), § 318(a)(2)(C) provides that if 5 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person will be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation.

In Rev. Rul. 67-274, 1967-2 C.B. 141, pursuant to a plan of reorganization, corporation *Y* acquired all of the stock of corporation *X* in exchange for voting stock of *Y*. Thereafter, *X* completely liquidated into *Y*. The ruling concludes that the two steps will not constitute a reorganization under § 368(a)(1)(B) followed by a liquidation under § 332, but instead will be considered a single acquisition of *X*'s assets in a reorganization under § 368(a)(1)(C).

ANALYSIS

A transfer of property may be respected as a § 351 exchange even if it is followed by subsequent transfers of the property as part of a prearranged, integrated plan. See Rev. Rul. 77-449, 1977-2 C.B. 110, amplified by Rev. Rul. 83-34, 1983-1 C.B. 79, and Rev. Rul. 83-156, 1983-2 C.B. 66; see also Rev. Rul. 2003-51, 2003-1 C.B. 938. However, a transfer of property in an exchange otherwise described in § 351 will not qualify as a § 351 exchange if, for example, a different treatment is warranted to reflect the substance of the transaction as a

whole. *See* Rev. Rul. 54–96, 1954–1 C.B. 111; Rev. Rul. 70–140, 1970–1 C.B. 73.

Under the facts of this revenue ruling, even though *P*'s transfer is part of a series of transactions undertaken as part of a prearranged, integrated plan involving successive transfers of the *LLC* interests, *P*'s transfer satisfies the formal requirements of § 351, including the requirement that *P* control *SI* within the meaning of § 368(c) immediately after the exchange, and an analysis of the transaction as a whole does not dictate that *P*'s transfer be treated other than in accordance with its form in order to reflect the substance of the transaction. Accordingly, *P*'s transfer is respected as a § 351 exchange, and no gain or loss is recognized by *P*. Similarly, § 351 applies to *SI*'s transfer, and no gain or loss is recognized by *SI*.

With regard to *S2*'s transfer and *LLC*'s election, if an acquiring corporation acquires all of the stock of a target corporation in an exchange otherwise qualifying as a § 351 exchange, and as part of a prearranged, integrated plan, the target corporation thereafter transfers its assets to the acquiring corporation in liquidation, the transaction is more properly characterized as a reorganization under § 368(a)(1)(D), to the extent it so qualifies. *See* Rev. Rul. 67–274; *see also* Rev. Rul. 2004–83, 2004–2 C.B. 157. Accordingly, under the circumstances described above, *S2*'s transfer and *LLC*'s election are more properly characterized as a reorganization under § 368(a)(1)(D) than as a § 351 exchange followed by a § 332 liquidation.

HOLDING

A transaction in which (1) a parent corporation transfers all of the interests in its limited liability company that is taxable as a corporation to the first subsidiary in exchange for additional stock, (2) the first subsidiary transfers all of the interests in the limited liability company to the second subsidiary in exchange for additional stock, (3) the second subsidiary transfers all of the interests in the limited liability company to the third subsidiary in exchange for additional stock, and (4) the limited liability company elects to be disregarded as an entity separate from its owner for federal income tax purposes effective after it is owned by the third subsidiary, is properly treated

for federal income tax purposes as two transfers of stock in exchanges governed by § 351 followed by a reorganization under § 368(a)(1)(D).

DRAFTING INFORMATION

The principal author of this revenue ruling is Stephanie D. Floyd of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Stephanie D. Floyd at (202) 317-6848 (not a toll-free number).

Section 167.—Depreciation

26 CFR 1.167(a)–2: Tangible property.
(Also § 168; 1.168(a)–1)

Rev. Rul. 2015–11

ISSUE

Is the capitalized cost of unrecoverable precious metal that is used in various manufacturing processes depreciable under §§ 167 and 168 of the Internal Revenue Code?

FACTS

Situation 1. *A* is a contract jeweler who fabricates jewelry to customers' specifications using gold supplied by the customers. *A* does not maintain an inventory of gold or completed jewelry, but to assist customers *A* fabricates and maintains gold sample jewelry showing currently available styles. *A*'s samples are not held for sale. Every 3 years *A* melts down the sample jewelry, recovering 100 percent of the gold content of the jewelry. For *A*'s purposes, the recovered gold is indistinguishable from gold that has not previously been used in sample jewelry and *A* reuses it in fabricating new sample jewelry. *A* capitalizes the cost of the gold into the basis of its sample jewelry.

Situation 2. *B* is a petroleum refiner. As part of its refining process, *B* uses a catalyst called prills, fabricated from platinum and other chemicals. Based upon engineering studies performed by *B*, *B* determines that approximately 10 percent of the platinum initially utilized to fabricate prills is lost over the course of the platinum's reasonably expected useful life in the refining process. The remaining 90 percent of the platinum is recoverable and becomes available to *B* for

other uses. *B* capitalizes the cost of the platinum.

Situation 3. *C* manufactures flat glass using the float manufacturing process. This process involves the use of molten tin, which provides the ideal surface to manufacture high-quality, flat glass. During the manufacturing process, the tin declines in purity and volume due to chemical reactions and vaporization. Additional tin is added as needed to maintain the level required for the production of the glass. After approximately 7 years, all of the original tin is lost due to chemical reactions and vaporization. *C* capitalizes the cost of the initial tin installed in the tin bath.

LAW

Section 167(a) provides as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear (including a reasonable allowance for obsolescence) of property used in a taxpayer's trade or business.

Section 1.167(a)–1(a) of the Income Tax Regulations provides that the depreciation allowance is that amount that should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property.

Section 1.167(a)–1(b) provides that for the purpose of § 167, the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in its trade or business or in the production of his income. This period is determined by reference to the taxpayer's experience with similar property taking into account present conditions and probable future developments.

Section 1.167(a)–2 provides that the depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence.

Section 1.168(a)–1(a) provides that § 168 determines the depreciation allow-

ance for tangible property that is of a character subject to the allowance for depreciation provided in § 167(a) and that is placed in service generally after December 31, 1986. See § 1.168(a)-1(b). Accordingly, tangible property to which § 1.168(a)-1(a) applies is property that is of a character subject to the allowance for depreciation provided in § 167(a) if the taxpayer shows that the property is subject to exhaustion, wear and tear, or obsolescence, and that the property has a determinable estimated useful life.

ANALYSIS

An asset is depreciable for federal income tax purposes to the extent that the taxpayer can show that the asset is subject to exhaustion, wear and tear, or obsolescence, and that the asset has a determinable estimated useful life. See *O'Shaughnessy v. Commissioner*, 332 F.3d 1125 (8th Cir. 2003), *aff'g in part, rev'g in part*, 2002-1 U.S.T.C. ¶ 50,235, 89 A.F.T.R. 2d 658 (D. Minn. 2001) (allowing depreciation for tin that declined in volume and purity as a result of glass manufacturing process); *Arkla, Inc. v. United States*, 765 F.2d 487 (5th Cir. 1985), *cert. denied*, 475 U.S. 1064 (1986) (allowing investment credit and depreciation for unrecoverable cushion gas but not for recoverable cushion gas); Rev. Rul. 97-54, 1997-2 C.B. 23 (adopting the reasoning of *Arkla, supra*). In *O'Shaughnessy*, the Eighth Circuit allowed the taxpayer to depreciate the initial installation of molten tin used in the float manufacturing process of flat glass. The Eighth Circuit concluded that whether an asset is depreciable for federal income tax purposes depends on the taxpayer's showing that the asset is subject to exhaustion and wear and tear. The Eighth Circuit reasoned that the tin's decline in volume and purity as a result of its use in the glass manufacturing process constituted "exhaustion, wear and tear" within the meaning of § 167, and therefore, the taxpayer appropriately depreciated the tin under § 168. In reaching its decision, the court concluded that Rev. Rul. 75-491, 1975-2 C.B. 19 (holding that the initial installation of molten tin used in the float manufacturing process of flat glass is not depreciable), was no longer persuasive in-

sofar as the ruling predated a substantial restructuring of the depreciation rules upon which its holding was based.

O'Shaughnessy, Arkla, Inc., and Rev. Rul. 97-54 require a fact-specific analysis of the extent to which precious metals used in various manufacturing processes are subject to exhaustion, wear and tear, or obsolescence (in other words, the extent to which precious metals are recoverable or unrecoverable) for determining whether such precious metals are depreciable under §§ 167 and 168. Accordingly, determining whether and the extent to which an asset is depreciable is based on an examination of the specific facts relating to the asset's use in a taxpayer's trade or business and whether the asset has a determinable estimated useful life. This analysis departs from the analysis previously used in Rev. Rul. 90-65, 1990-2 C.B. 41, as corrected by Announcement 91-15, 1991-5 I.R.B. 49, and Rev. Rul. 75-491.

Rev. Rul. 90-65 and Rev. Rul. 75-491 distinguished the treatment of a precious metal that remains available to the owner but is consumed in production from a material such as "line pack gas" or "cushion gas," which is lost for any other potential use upon its initial installation into a facility (with the facility itself being a depreciable asset). Rev. Rul. 75-491 held that the initial installation of molten tin used in the float manufacturing process of flat glass is not depreciable property. The ruling recognized that, although a portion of the initial tin is consumed in the manufacturing operation, the remaining portion is undiminished in value and once restored to its original level (by adding additional quantities during the year) is property that is "essentially the same that existed at the beginning of the year." Accordingly, the ruling concluded that the initial installation of molten tin was not depreciable and that the cost of tin consumed during the year in the production of the glass was deductible under section 162, subject to being included in inventory as a production cost.

Rev. Rul. 90-65 amplified the holding of Rev. Ruling 75-491 by clarifying that the principles of Rev. Rul. 75-491 apply not only when a recoverable element is

used in its natural state, but also when an economically recoverable precious metal is fabricated into items of property used in the taxpayer's trade or business. Specifically, Rev. Rul. 90-65 held that if an economically recoverable precious metal is fabricated into items of property used in the taxpayer's trade or business and the cost of that metal is more than half the cost of the property, the cost of the metal is nondepreciable and is accounted for separately from the item into which it is fabricated.

The analyses in Rev. Rul. 75-491 and Rev. Rul. 90-65 are inconsistent with *Arkla, Inc.* and Rev. Rul. 97-54, which require an analysis of the specific facts surrounding an asset's use in a taxpayer's trade or business when determining whether and the extent to which an asset is depreciable. In addition, Rev. Rul. 75-491 and Rev. Rul. 90-65 have been supplanted by more recent authorities such as *O'Shaughnessy*. Accordingly, this revenue ruling adopts the factual analysis approach as applied by those later authorities. Further, because the factual analysis approach permits depreciation of initial installations of certain precious metals, it is no longer relevant whether the cost of those initial installations is more than half the cost of the overall fabricated property.

In Situation 1, the gold used to manufacture sample jewelry can be recovered and reused by A in A's trade or business in a manner that is indistinguishable from other gold that has never been fabricated, used, and recovered. The utility of the gold does not diminish as a result of its having previously been fabricated into sample jewelry. Accordingly, the gold is not subject to exhaustion, wear and tear, or obsolescence and as a result, is not depreciable.

In Situation 2, approximately 10 percent of the platinum is lost over the course of its expected useful life and is not recoverable for reuse. Accordingly, approximately 10 percent of the platinum will undergo exhaustion, wear and tear, or obsolescence over a determinable useful life. To the extent that the platinum will be lost and is not recoverable for reuse (i.e., approximately 10 percent of the total amount), B may depreciate the capitalized cost of such platinum under §§ 167 and 168. To the

extent that any of the platinum is recoverable for reuse (i.e., approximately 90 percent of the total amount), *B* may not depreciate the capitalized cost of such platinum.

In Situation 3, all of the original tin used in the glass manufacturing process is lost due to chemical reactions and evaporation after about 7 years. Thus, all of the original tin will undergo exhaustion, wear and tear, or obsolescence over a determinable useful life. Therefore, *C* may depreciate the capitalized cost of all the entire original tin under §§ 167 and 168.

HOLDING

The capitalized cost of unrecoverable precious metals that are used in various manufacturing processes is depreciable under §§ 167 and 168 of the Code. The capitalized cost of any recoverable precious metal is not depreciable under §§ 167 and 168.

APPLICATION

Any change in a taxpayer's treatment of the cost of precious metals to conform with this revenue ruling is a change in method of accounting that must be made in accordance with §§ 446 and 481, the regulations thereunder, and the applicable administrative procedures. See section 6.01 of Rev. Proc. 2015-14, 2015-5 I.R.B. 450 (or successor guidance). The amount of the § 481(a) adjustment must account for the proper amount of the depreciation allowable that is required to be capitalized under any provision of the Code (for example, § 263A) as of the beginning of the year of change.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 75-491 is revoked.

Rev. Rul. 90-65 is revoked.

DRAFTING INFORMATION

The principal author of this revenue ruling is Douglas H. Kim of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Kim at (202) 317-7005 (not a toll-free number).

26 CFR 1.446-3T: Notional Principal Contracts; Swaps with Nonperiodic Payments.

26 CFR 1.956-2T: Definition of United States property (temporary).

TD 9719

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Notional Principal Contracts; Swaps with Nonperiodic Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations amending the treatment of nonperiodic payments made or received pursuant to certain notional principal contracts. These regulations provide that, subject to certain exceptions, a notional principal contract with a nonperiodic payment, regardless of whether it is significant, must be treated as two separate transactions consisting of one or more loans and an on-market, level payment swap. This document also contains temporary regulations regarding an exception from the definition of United States property. These regulations affect parties making and receiving payments under notional principal contracts, including United States shareholders of controlled foreign corporations and tax-exempt organizations. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG-102656-15) on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date.* These regulations are effective on May 8, 2015.

Applicability Date. For the dates of applicability, see §§ 1.446-3T(j)(2) and 1.956-2T(f).

FOR FURTHER INFORMATION

CONTACT: Regarding the regulations under section 446, Alexa T. Dubert or Anna H. Kim at (202) 317-6895; regarding the regulations under section 956, Kristine A. Crabtree at (202) 317-6934 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Embedded Loan Rule

On October 14, 1993, the Treasury Department and the IRS published final regulations (TD 8491) under section 446(b) of the Internal Revenue Code (Code) in the **Federal Register** (58 FR 53125) relating to the timing of income, deduction, gain, or loss with respect to payments, including nonperiodic payments, made or received pursuant to a notional principal contract (NPC) (the 1993 Regulations). See § 1.446-3. Under the 1993 Regulations, when an NPC includes a “significant” nonperiodic payment, the contract is generally treated as two separate transactions consisting of an on-market, level payment swap and a loan (the embedded loan rule). The loan must be accounted for by the parties to the contract separately from the swap. The time-value component associated with the loan is recognized as interest for all purposes of the Code.

A nonperiodic payment commonly arises when a party to an NPC makes below-market periodic payments or receives above-market periodic payments under the terms of the contract. A party making below-market periodic payments or receiving above-market periodic payments would also typically be required to make an upfront payment to the counterparty to compensate for the off-market coupon payments specified in the contract. For example, if A and B enter into an off-market interest rate swap the terms of which require A to make periodic below-market, fixed rate payments to B in exchange for A receiving periodic on-market, floating-rate payments from B, then A typically will compensate B for receiving the below-market fixed rate payments by making an upfront payment at the outset of the interest rate swap so that the present value of the fixed rate leg of the swap will equal the present value of the floating rate leg of the swap.

II. *Nonperiodic (Upfront) Payments Arising from the Standardization of Contract Terms*

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No. 111–203, 124 Stat. 1376, Title VII (the Dodd-Frank Act), among other things: (1) provides for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposes clearing and trade execution requirements on many standardized swap contracts; (3) creates rigorous recordkeeping and real-time reporting regimes; and (4) enhances rulemaking and enforcement authority of various federal regulators with respect to entities and intermediaries within their jurisdiction. As part of implementing the Dodd-Frank Act, the Commodity Futures Trading Commission (CFTC) has mandated that certain swap contracts (cleared contracts), including swaps that are NPCs under § 1.446–3, be cleared through U.S.-registered derivatives clearing organizations. The Securities and Exchange Commission (SEC) has not yet mandated clearing of any security-based swaps through clearing agencies (which, together with derivatives clearing organizations, are referred to herein as U.S.-registered clearinghouses).

To facilitate clearing and exchange trading, cleared contracts generally have standardized terms, which often give rise to upfront payments. For example, a Market Agreed Coupon interest rate swap (MAC) has standardized terms, including a standardized coupon rate (or fixed rate). Because the fixed rate is set in advance, it is unlikely that the fixed rate will equal the market rate on the start date of the MAC. Consequently, except for the rare instance when the market rate for a particular MAC equals the fixed rate, a MAC with a standardized coupon rate will be off-market and will require an upfront payment to equalize the present value of the payment obligations under the contract.

Certain over-the-counter markets in swap contracts not subject to clearing with

U.S.-registered clearinghouses (uncleared contracts) also have voluntarily begun to adopt terms similar to the MAC, including pre-defined, market-agreed start and end dates, payment dates, and fixed coupons to achieve greater standardization of contract terms. Similar to cleared contracts, these uncleared contracts are resulting in an increasing number of upfront payments.

III. *Margin Requirements*

As part of establishing a risk-management framework, the SEC, CFTC, and certain other federal regulators (collectively, the Regulators) are required by the Dodd-Frank Act to propose and adopt collateral requirements for cleared contracts and certain uncleared contracts. These requirements are typically referred to as “margin” requirements in the context of contracts between entities that are regulated by the Regulators (regulated entities) and, in these temporary regulations, the term “margin” is used in the context of cleared and uncleared contracts between regulated entities and the term “collateral” is used in the context of uncleared contracts between unregulated entities.

A. Margin requirements on cleared contracts

U.S.-registered clearinghouses manage credit risk (the risk of counterparty default) in part by requiring that each party to a cleared contract provide various types of margin in an amount that fully collateralizes the credit risk on the contract. Because credit risk starts at the inception of the contract and continues throughout the term of the contract, the requirement to exchange margin sufficient to fully collateralize credit risk begins when the parties enter into the contract. To ensure that credit risk on the contract is fully collateralized, the contract is marked to market on a daily basis (beginning on the day the contract is entered into) and margin is

exchanged by the parties based on the mark-to-market value.

For example, if A and B enter into a cleared off-market interest rate swap contract the terms of which require A to make periodic below-market, fixed rate payments to B in exchange for A receiving periodic on-market, floating-rate payments from B, then A will make an upfront payment to the clearinghouse (to be passed on to B) so that the present value of the fixed rate leg of the swap will equal the present value of the floating rate leg of the swap. A has credit risk with respect to that payment because, if the clearinghouse (or A’s clearing member) were to default, A may not receive the full benefit of receiving on-market, floating rate payments in exchange for making below-market fixed rate payments for the term of the contract. When the U.S.-registered clearinghouse makes the upfront payment to B, the U.S.-registered clearinghouse similarly has credit risk with respect to B (or B’s clearing member). To eliminate the credit risk to A and B, the parties are required to post margin. More specifically, B (the ultimate recipient of the upfront payment) is required to make a payment of initial variation margin to the U.S.-registered clearinghouse, generally no later than the end of the business day on which the upfront payment is made, in an amount that is equal (or substantially equal) to the amount of the upfront payment.¹ After receiving B’s initial variation margin payment, the U.S.-registered clearinghouse will pay the same amount to A.² Consequently, A is fully collateralized on the exposure on the swap contract at the end of the day the upfront payment is made.

In addition to initial variation margin, U.S.-registered clearinghouses manage credit risk by requiring that each party to a cleared contract provide daily variation margin. Daily variation margin is a cash payment made on a daily or intra-day basis between the counterparties to a contract to protect against the risk of counter-

¹The total amount of initial variation margin posted by B may not equal the amount of A’s upfront payment due to either: (1) the netting of B’s notional exposure to A, or to the U.S.-registered clearinghouse, as a result of other transactions; or (2) changes in the value of the contract between the time the contract is entered into and the time when the required margin is paid, requiring daily variation margin to be added to or subtracted from B’s initial variation margin payment, as the case may be. However, on a transaction-by-transaction basis, the payment of initial variation margin by B should equal (or closely approximate) A’s upfront payment when any daily variation margin is treated as separate from the initial variation margin posted on that day.

²In each case, unless A and B are clearing members of the U.S.-registered clearinghouse, the payment is made to or through each party’s clearing member (that is, a futures commission merchant, broker, or dealer who is a member of the clearinghouse), which may be an affiliate of that party.

party default. The rules of U.S.-registered clearinghouses generally require that daily variation margin be paid in an amount equal to the change in the fair market value of the contract (the mark-to-market value). Thus, A and B will continue to mark to market the cleared contract and exchange daily variation margin based on those values on a daily basis for the entire term of the contract.

B. Margin requirements on uncleared contracts between regulated entities and the exchange of collateral on uncleared contracts between unregulated entities

The margin requirements proposed by the Regulators for uncleared contracts are expected to appropriately address the credit risk posed by a counterparty that is a regulated entity and the risks associated with an uncleared contract and are expected to be as stringent as those required for cleared contracts.³ In addition, unregulated entities that enter into uncleared contracts may exchange collateral sufficient to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract (beginning on the day the contract is entered into).

IV. Other Recent Guidance and Comments Regarding the Embedded Loan Rule as Applied to Upfront Payments on Cleared and Uncleared Contracts

The Dodd-Frank Act has led to significant changes in market practices for cleared and uncleared contracts, including the increased volume of cleared and uncleared contracts with upfront payments. Under the 1993 Regulations, the parties to an NPC with an upfront payment are required to determine whether the upfront payment is a significant nonperiodic payment. If the payment is significant, the embedded loan rule will apply. In addition, under the 1993 Regulations, for purposes of section 956 (regarding United States property), the Commissioner may treat any nonperiodic payment, whether or not significant, as one or more loans.

On May 11, 2012, the Treasury Department and the IRS published temporary regulations under section 956 (TD 9589) in the **Federal Register** (77 FR 27612). On the same date, a notice of proposed rulemaking (REG-107548-11) by cross-reference to the temporary regulations was published in the **Federal Register** (77 FR 27669). These regulations excepted from the definition of United States property under section 956 certain obligations arising from upfront payments on cleared contracts with respect to which full initial variation margin is posted (the Section 956 Regulations). In response to the request for comments and, more generally, because of the growing number of upfront payments on cleared and uncleared contracts, the Treasury Department and the IRS have received several comment letters noting the potentially burdensome tax consequences associated with treating an upfront payment as one or more loans. For example, the 1993 Regulations do not define what constitutes a “significant” nonperiodic payment. Instead, examples in the 1993 Regulations illustrate contracts with and without significant nonperiodic payments and explain how to determine significance by comparing the nonperiodic payment to the present value of the total amount of payments due under the contract. Commenters have noted that the lack of a definition in the embedded loan rule for when such a payment is significant creates uncertainty and that taxpayers have developed different ways to determine “significance” for this purpose.

In addition, commenters have argued that receiving an upfront payment and posting cash margin back to the payor of the upfront payment lacks the most important attribute of indebtedness because the recipient lacks discretion as to the payment’s use. Commenters also have raised concerns of increased compliance burdens arising from withholding and information reporting resulting from the increasing number of upfront payments treated as loans. Commenters specifically cite the difficulty of satisfying information reporting on upfront payments arising from cleared contracts because a U.S.-regis-

tered clearinghouse is interposed between the first party and second party once a contract is submitted and accepted for clearing.

Commenters also have raised concerns that receipt by a tax-exempt organization of an upfront payment arising from entering into a standardized cleared or uncleared contract (the loan separated from the on-market swap under the embedded loan rule) may cause income earned on the tax-exempt organization’s deployment of the upfront payment to constitute unrelated business taxable income under the debt-financed property rules of section 514. Finally, commenters have requested that the exception in the Section 956 Regulations be extended to uncleared contracts with upfront payments with respect to which full initial variation margin is posted.

Explanation of Provisions

The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**. The temporary regulations under section 446 simplify the embedded loan rule and provide two exceptions to that rule. The temporary regulations under section 956 provide an exception to the definition of United States property with respect to certain notional principal contracts subject to margin or collateral requirements as described in the temporary regulations under section 446.

I. Simplification of the Embedded Loan Rule

Because excepting non-significant nonperiodic payments from the embedded loan rule is not functioning as a rule of administrative convenience as intended, these temporary regulations eliminate that exception. Instead, other than contracts for which there is an explicit exception, the temporary regulations treat all notional principal contracts that have nonperiodic payments as including one or more loans. The Treasury Department and the

³See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (October 3, 2014); Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO), Margin Requirements for Non-centrally Cleared Derivatives (September 2013).

IRS have determined that, unless an exception applies, the economic loan that is inherent in a nonperiodic payment should be taxed as one or more loans, and that it is reasonable to require taxpayers to separate the loan or loans from an NPC in the case of any nonperiodic payment, regardless of the relative size of such payment. Taxpayers may implement this change upon publication in the **Federal Register**, but for those taxpayers that need additional time, the temporary regulations delay the applicability date of this rule until November 4, 2015.

II. *Exceptions to the Embedded Loan Rule*

The temporary regulations provide two independent exceptions from the embedded loan rule. First, except for purposes of sections 514 and 956, the temporary regulations provide an exception for a nonperiodic payment made under an NPC with a term of one year or less (short-term exception).

Second, the temporary regulations provide an exception for certain NPCs with nonperiodic payments that are subject to prescribed margin or collateral requirements. The embedded loan rule is intended to address situations when one party to a contract provides cash to the counterparty and is compensated for that cash with a direct or indirect interest payment. The Treasury Department and the IRS have concluded, however, that the same concerns do not exist when a party pays or receives an upfront payment and must immediately collect or post an equivalent amount of cash margin or collateral. Accordingly, in those circumstances, the Treasury Department and the IRS have determined that the embedded loan rule should not apply to the upfront payment.

In order to qualify for the exception, the regulations require both that the margin or collateral posted and collected be paid in cash and that the parties to the contract be required to post and collect margin or collateral in an amount that fully collateralizes the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract. The mark-to-market exposure on a

cleared contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount equal to the daily change in the fair market value of the contract, and on an uncleared contract if it is subject to equivalent margin or collateral requirements (full margin exception). A taxpayer may use the full margin exception without regard to whether the contract qualifies for the short-term exception.

The Treasury Department and the IRS request comments on whether there are other circumstances in which the embedded loan rule should not apply. For example, there may be circumstances in which time value is appropriately accounted for under the contract because applying the embedded loan rule would not alter the tax consequences of the contract. In particular, the Treasury Department and the IRS request comments on whether it is necessary to require taxpayers to apply the embedded loan rule to NPCs with nonperiodic payments that are subject to mark-to-market accounting.

Finally, the Treasury Department and the IRS request comments on all other aspects of the temporary and proposed rules, including but not limited to any anticipated effects on market participants' behavior, the applicability of the full margin exception only in cases in which cash margin is posted, or possible effects on the goal of the Dodd-Frank Act to encourage centralized clearing of swaps.

III. *Exception to the Definition of United States Property*

The temporary regulations under section 956 provide an exception to the definition of United States property for certain obligations of United States persons arising from upfront payments made with respect to notional principal contracts that qualify for the full margin exception to the embedded loan rule in the temporary regulations under section 446. To qualify for the United States property exception, the upfront payment must be made by a controlled foreign corporation (as defined in section 957(a)) that is either a dealer in

securities under section 475(c)(1) or a dealer in commodities.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13653. 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 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, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small entities.

Drafting Information

The principal authors of these regulations are Alexa T. Dubert and Anna H. Kim of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

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 1.446-3 is amended by:

1. Revising paragraph (g)(4).
2. Revising paragraph (g)(6), *Examples* 2, 3 and 4.
3. Redesignating paragraph (j) as (j)(1) and revising the paragraph heading of paragraph (j)(1).
4. Adding paragraph (j)(2).

The revisions and addition to read as follows:

§ 1.446-3 Notional principal contracts.

* * * * *

(g) * * *

(4) [Reserved]. For further guidance, see § 1.446-3T(g)(4).

* * * * *

(6) * * *

Example 2. [Reserved]. For further guidance, see § 1.446-3T(g)(6), Example 2.

Example 3. [Reserved]. For further guidance, see § 1.446-3T(g)(6), Example 3.

Example 4. [Reserved]. For further guidance, see § 1.446-3T(g)(6), Example 4.

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(j) *Effective/applicability date*—(1) * * *

(2) [Reserved]. For further guidance, see § 1.446-3T(j)(2).

Par. 3. Section 1.446-3T is added to read as follows:

§ 1.446-3T Notional principal contracts (temporary).

(a) through (g)(3) [Reserved]. For further guidance, see § 1.446-3(a) through (g)(3).

(4) *Notional principal contracts with nonperiodic payments*—(i) *General rule*. Except as provided in paragraph (g)(4)(ii) of this section, a notional principal contract with one or more nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and one or more loans. The loan(s) must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan(s) is not included in the net income or net deduction from the swap under § 1.446-3(d), but it is recognized as interest for all purposes of the Internal Revenue Code. See paragraph (g)(6) Example 2 of this section.

(ii) *Exceptions*—(A) *Notional principal contract with a term of one year or less*—(1) *General rule*. Except for purposes of sections 514 and 956, paragraph (g)(4)(i) of this section does not apply to a notional principal contract if the term of the contract is one year or less. For purposes of this paragraph (g)(4)(ii)(A), the term of a notional principal contract is the stated term of the contract, inclusive of any extensions (optional or otherwise) provided for in the terms of the contract, without regard to whether any extension is

unilateral, is subject to approval by one or both parties to the contract, or is based on the occurrence or non-occurrence of a specified event.

(2) *Anti-abuse rule*. For purposes of determining the term of a contract under paragraph (g)(4)(ii)(A)(1) of this section, the Commissioner may treat two or more contracts as a single contract if a principal purpose of entering into separate contracts is to qualify for the exception set forth in paragraph (g)(4)(ii)(A)(1) of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Notional principal contract subject to margin or collateral requirements*. Subject to the requirements in paragraph (g)(4)(ii)(C) of this section, paragraph (g)(4)(i) of this section does not apply to a notional principal contract if the contract is described in paragraph (g)(4)(ii)(B)(1) or (2) of this section. See § 1.956-2T(b)(1)(xi) for a related exception under section 956.

(1) The contract is cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or by a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, and the derivatives clearing organization or clearing agency requires the parties to the contract to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract. The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount equal to the daily change in the fair market value of the contract. See paragraph (g)(6) Example 3 of this section.

(2) The parties to the contract are required, pursuant to the terms of the contract or the requirements of a federal reg-

ulator, to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract. The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin or collateral in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin or collateral in an amount equal to the daily change in the fair market value of the contract. For purposes of this paragraph (g)(4)(ii)(B)(2), the term “federal regulator” means the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Act. See paragraph (g)(6) Example 4 of this section.

(C) *Limitations and special rules*—(1) *Cash requirement*. A notional principal contract is described in paragraph (g)(4)(ii)(B) of this section only to the extent the parties post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) by paying and receiving the required margin or collateral in cash. The term “cash” includes U.S. dollars or cash in any currency in which payment obligations under the notional principal contract are denominated.

(2) *Excess margin or collateral*. For purposes of paragraph (g)(4)(ii)(B)(2) of this section, if the amount of cash margin or collateral posted and collected is in excess of the amount necessary to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract, any excess is subject to the rule in paragraph (g)(4)(i) of this section.

(3) *Margin or collateral paid and received in cash and other property*. If the parties to the contract post and collect both cash and other property to satisfy margin or collateral requirements to collateralize the mark-to-market exposure on the contract (including the exposure on

the nonperiodic payment), any excess of the nonperiodic payment over the cash margin or collateral posted and collected is subject to the rule in paragraph (g)(4)(i) of this section.

(5) [Reserved]. For further guidance, see § 1.446-3(g)(5).

(6) *Examples through Example 1.* [Reserved]. For further guidance, see § 1.446-3(g)(6), *Examples through Example 1.*

Example 2. Nonperiodic payment. (i) On January 1, 2016, unrelated parties M and N enter into an interest rate swap contract. Under the terms of the contract, N

agrees to make five annual payments to M equal to LIBOR times a notional principal amount of \$100 million. In return, M agrees to pay N 6% of \$100 million annually, plus an upfront payment of \$15,163,147 on January 1, 2016. At the time M and N enter into the contract, the rate for similar on-market swaps is LIBOR to 10%, and N provides M with information that the amount of the upfront payment was determined as the present value, at 10% compounded annually, of five annual payments from M to N of \$4,000,000 (4% of \$100,000,000). The contract does not require the parties to post and collect margin or collateral to collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract.

(ii) The exceptions in paragraphs (g)(4)(ii)(A) and (B) of this section do not apply. Under paragraph (g)(4)(i) of this section, the transaction is recharacterized as consisting of both a \$15,163,147 loan from M to N that N repays in installments over the term of the contract and an interest rate swap between M and N in which M immediately pays the installment payments on the loan back to N as part of its fixed payments on the swap in exchange for the LIBOR payments by N.

(iii) The upfront payment is recognized over the life of the contract by treating the \$15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10%, M and N account for the principal and interest on the loan as follows:

	Level Payment	Interest Component	Principal Component
2016	\$ 4,000,000	\$1,516,315	\$ 2,483,685
2017	4,000,000	1,267,946	2,732,054
2018	4,000,000	994,741	3,005,259
2019	4,000,000	694,215	3,305,785
2020	4,000,000	363,636	3,636,364
	\$20,000,000	\$4,836,853	\$15,163,147

(iv) M recognizes interest income, and N claims an interest deduction, each taxable year equal to the interest component of the deemed installment payments on the loan. These interest amounts are not included in the parties' net income or net deduction from the swap contract under § 1.446-3(d). The principal components are needed only to compute the interest component of the level payment for the following period and do not otherwise affect the parties' net income or net deduction from this contract.

(v) N also makes swap payments to M based on LIBOR and receives swap payments from M at a fixed rate that is equal to the sum of the stated fixed rate and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on this swap is 10%, which is the sum of the stated rate of 6% and the rate calculated by dividing the annual loan payment of \$4,000,000 by the notional principal amount of \$100,000,000, or 4%. Using the methods provided in § 1.446-3(e)(2), the fixed swap payments from M to N of \$10,000,000 (10% of \$100,000,000) and the LIBOR swap payments from N to M are included in the parties' net income or net deduction from the contract for each taxable year.

Example 3. Full margin – cleared contract. (i) A, a domestic corporation enters into an interest rate swap contract with unrelated counterparty B. The contract is required to be cleared and is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). The standardized terms of the contract provide that A, for a term of X years, will pay B a fixed coupon of 1% per year and receive a floating coupon on a notional principal amount of \$Y. When A and B enter into the interest rate swap, the market coupon for similar interest rate swaps is 2% per year. The DCO requires A to make an upfront payment to compensate B for the below-market annual coupon payments that B will receive, and A makes the

upfront payment in cash. The DCO also requires B to post initial variation margin in an amount equal to the upfront payment and requires each party to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. B posts the initial variation margin in U.S. dollars, and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(1) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

Example 4. Full margin – uncleared contract. (i) On June 1, 2016, P, a domestic corporation, enters into an interest rate swap contract with an unrelated domestic counterparty, CP. Under the terms of the contract, CP agrees to make five annual payments to P equal to a specified contract rate of 3% times the notional amount of \$10,000,000 plus an upfront payment of \$1,878,030. In exchange, P agrees to make five annual payments to CP equal to the same notional amount times LIBOR. At the time the parties enter into the contract, the fixed rate for an on-market swap is 7.52%. The contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. However, pursuant to the terms of the contract, P is obligated to post \$1,878,030 as collateral with CP, and P and CP are obligated to post and collect collateral each business day in an amount equal to the daily change in the fair market value of the contract for the entire term of the contract. All collateral on the contract is required to be in U.S. dollars.

(ii) Because the contract is required to be collateralized in an amount equal to the upfront payment

and changes in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(2) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

(h) through (j)(1) [Reserved]. For further guidance, see § 1.446-3(h) through (j)(1).

(2) *Application of § 1.446-3T(g)(4).* The rules provided in paragraph (g)(4)(i) of this section apply to notional principal contracts entered into on or after November 4, 2015. Taxpayers may apply the rules provided in paragraph (g)(4)(i) of this section to notional principal contracts entered into before November 4, 2015. The rules provided in paragraph (g)(4)(ii) of this section apply to notional principal contracts entered into on or after May 8, 2015. Taxpayers may apply the rules provided in paragraph (g)(4)(ii) of this section to notional principal contracts entered into before May 8, 2015. For the rules that apply to notional principal contracts with nonperiodic payments entered into before the dates set forth in this paragraph (j)(2), see § 1.446-3(g)(4) as contained in 26 CFR part 1, revised April 1, 2015.

(k) *Expiration date.* The applicability of paragraph (g)(4) of this section and paragraph (g)(6) *Examples 2, 3 and 4* of this section expires on May 7, 2018.

Par. 4. Section 1.956-2T is amended by revising paragraphs (b)(1)(xi), (f) and (g) to read as follows:

§ 1.956-2T Definition of United States property (temporary).

* * * * *

(b) * * *

(1) * * *

(xi) An obligation of a United States person arising from a nonperiodic payment by a controlled foreign corporation (within the meaning of section 957(a)) with respect to a notional principal contract described in § 1.446-3T(g)(4)(ii)(B)(1) or (2) if the following conditions are satisfied—

(A) The controlled foreign corporation that makes the nonperiodic payment is either a dealer in securities (within the meaning of section 475(c)(1)) or a dealer in commodities; and

(B) The conditions set forth in § 1.446-3T(g)(4)(ii)(C)(1) (relating to full margin or collateral in cash) are satisfied.

(C) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(xi):

Example 1. Full margin – cleared contract. (i) A domestic corporation (USC) wholly owns a controlled foreign corporation (CFC) that is a dealer in securities under section 475(c)(1). CFC enters into an interest rate swap contract with unrelated counterparty B. The contract is required to be cleared and is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). CFC is not a member of the DCO. CFC uses a U.S. affiliate (CM), which is a member of the DCO, as its clearing member to submit the contract to be cleared. CM is a domestic corporation that is wholly owned by USC. The standardized terms of the contract provide

that, for a term of X years, CFC will pay B a fixed coupon of 1% per year and receive a floating coupon on a notional principal amount of \$Y. When CFC and B enter into the contract, the market coupon for similar interest rate swaps is 2% per year. The DCO requires CFC to make an upfront payment to compensate B for the below-market annual coupon payments that B will receive, and CFC makes the upfront payment in cash. CFC makes the upfront payment through CM to the DCO, which then makes the payment to B. The DCO also requires B to post initial variation margin in an amount equal to the upfront payment and requires each party to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. B posts the initial variation margin in U.S. dollars, which is received by CFC (through DCO and CM), and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in § 1.446-3T(g)(4)(ii)(B)(1). Furthermore, because the additional conditions set forth in this paragraph (b)(1)(xi) are satisfied, the obligation of CM arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

Example 2. Full margin – uncleared contract. (i) Assume the same facts as in *Example 1*, except for the following. CFC's counterparty to the contract is USC, CM is not involved, and the contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. The contract requires CFC to make an upfront payment to compensate USC for the below-market annual coupon payments that USC will receive, and CFC makes the upfront payment in U.S. dollars. Pursuant to the requirements of a federal regulator, USC is obligated to post initial variation margin with CFC in an amount equal to CFC's upfront payment, and USC and CFC are obligated to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the

contract. USC posts the initial variation margin in U.S. dollars, which is received by CFC, and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in § 1.446-3T(g)(4)(ii)(B)(2). Furthermore, because the additional conditions set forth in this paragraph (b)(1)(xi) are satisfied, the obligation of USC arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

* * * * *

(f) *Effective/applicability date.* Paragraph (b)(1)(xi) of this section applies to payments described in § 1.956-2T(b)(1)(xi) made on or after May 8, 2015. Taxpayers may apply the rules of paragraph (b)(1)(xi) to payments made before May 8, 2015.

(g) *Expiration date.* The applicability of paragraph (b)(1)(xi) of this section expires on May 7, 2018.

John M. Dalrymple
*Deputy Commissioner for
Services and Enforcement.*

Approved: April 29, 2015

Mark J. Mazur
*Assistant Secretary of the
Treasury (Tax Policy).*

(Filed by the Office of the Federal Register on May 7, 2015, 8:45 a.m., and published in the issue of the Federal Register for May 8, 2015, 80 F.R. 26437)

Part III. Administrative, Procedural, and Miscellaneous

Designation of Private Delivery Services

Notice 2015-38

This notice updates the list of designated private delivery services (“designated PDSs”) set forth in Notice 2004-83, 2004-2 C.B. 1030, for purposes of the timely mailing treated as timely filing/paying rule of section 7502 of the Internal Revenue Code, provides rules for determining the postmark date for these services, and provides a new address for submitting documents to the Internal Revenue Service (“IRS”) with respect to an application for designation as a designated PDS. These changes are effective May 6, 2015.

BACKGROUND

Section 7502(f) authorizes the Secretary to designate certain private delivery services (“PDSs”) for the timely mailing treated as timely filing/paying rule of section 7502. Revenue Procedure 97-19, 1997-1 C.B. 644, provided rules to apply to be a designated PDS, as well as setting forth the criteria for eligibility for designation as a PDS. Originally, under Rev. Proc. 97-19, there was a semi-annual application period for designation as a PDS with set dates for announcing the list of designated PDSs to the public. The current rules provide that there is one annual application period to apply for designation, ending on June 30th, and the list of designated PDSs is updated as PDSs are added or removed from the list. See Notice 97-50, 1997-2 C.B. 305, and Notice 99-41, 1999-2 C.B. 325. In addition, the address for submitting applications listed in Rev. Proc. 97-19 was updated in Notice 2001-62, 2001-2 C.B. 307.

Notice 97-26, 1997-1 C.B. 413, provided the first list of designated PDSs as well as special rules to determine the date that will be treated as the postmark date for purposes of section 7502, including certain presumption rules and rules for overcoming the presumption. The list of designated PDS services was updated by Notice 97-50, Notice 99-41, Notice

2001-62, Notice 2002-62, 2002-2 C.B. 574, and Notice 2004-83.

NATURE OF CHANGES

The IRS is adding four new delivery services to the list of designated delivery services. Federal Express Corporation (“FedEx”): FedEx First Overnight, FedEx International First Next Flight Out, and FedEx International Economy; and United Parcel Service (“UPS”): UPS Next Day Air Early AM are added to the list published in Notice 2004-83.

In addition, the IRS is removing five delivery services previously designated that are no longer provided. Notice 2004-83 contained five services provided by DHL Express (DHL Same Day Service; DHL Next Day 10:30 am; DHL Next Day 12:00 pm; DHL Next Day 3:00 pm; and DHL 2nd Day Service) that had been designated for purposes of section 7502. Since the publication of Notice 2004-83, DHL Express substantially altered or discontinued its delivery services within the domestic United States, and the DHL Express services listed in Notice 2004-83 are no longer provided. Accordingly, the DHL Express services listed in Notice 2004-83 are no longer designated.

This notice also updates, and consolidates in one place, the rules for determining the postmark date for documents delivered by a designated delivery service.

Finally, this notice modifies Rev. Proc. 97-19, as modified by Notice 2001-62, to provide a new address to submit an application for PDS designation. This new address may also be used to request administrative review of a letter of denial of designation, appeal a letter confirming the denial of designation, provide written notification of any change in application information, and appeal a proposed revocation letter.

LIST OF DESIGNATED PDSs

Effective May 6, 2015, the list of designated PDSs is as follows:

FedEx:

1. FedEx First Overnight
2. FedEx Priority Overnight
3. FedEx Standard Overnight
4. FedEx 2 Day

5. FedEx International Next Flight Out
6. FedEx International Priority
7. FedEx International First
8. FedEx International Economy

UPS:

1. UPS Next Day Air Early AM
2. UPS Next Day Air
3. UPS Next Day Air Saver
4. UPS 2nd Day Air
5. UPS 2nd Day Air A.M.
6. UPS Worldwide Express Plus
7. UPS Worldwide Express.

Only the specific delivery services enumerated in this list are designated delivery services for purposes of section 7502(f). FedEx and UPS are not designated with respect to any type of delivery service not enumerated in this list. Taxpayers are cautioned that merely because a delivery service is provided by FedEx or UPS, it does not mean that the service is designated for purposes of the timely mailing treated as timely filing/paying rule of section 7502.

This list of designated PDSs and designated services will remain in effect until further notice. The IRS will publish a subsequent notice setting forth a new list only if a designated PDS (or service) is added to, or removed from, the current list, or if there is a change to the application and/or appeal procedures. Delivery services requesting to be designated in time for an upcoming filing season must submit applications by June 30th of the year preceding that filing season, as required by Rev. Proc. 97-19, as modified by Notice 97-50.

SPECIAL RULES FOR DETERMINING POSTMARK DATE IN THE CASE OF A PDS

Section 7502(f)(2)(C) requires a PDS to either (1) record electronically to its data base (kept in the regular course of its business) the date on which an item was given to the PDS for delivery or (2) mark on the cover of the item the date on which an item was given to the PDS for delivery. Under section 7502(f)(1), the date recorded or the date marked by the PDS under section 7502(f)(2)(C) is treated as the postmark date for purposes of section 7502.

For each PDS designated in this notice, the delivery service records electronically

the date on which an item was given to it for delivery, which is treated as the postmark date for purposes of section 7502. Under this notice, the postmark date for an item delivered after the due date is presumed to be the day that precedes the delivery date by an amount of time that equals the amount of time it would normally take for an item to be delivered under the terms of the specific type of delivery service used (*e.g.*, two days before the actual delivery date for a two-day delivery service). Taxpayers who wish to overcome this presumption must provide information that shows that the date recorded in the delivery service's electronic data base is on or before the due date, such as a written confirmation produced and issued by the delivery service. Each delivery service stores the date recorded in its database only for a finite period, but for no less than six months. Senders or recipients using a designated delivery service can obtain information concerning the date recorded by contacting the designated delivery service. Contact information for each

delivery service is available on the company's website.

NEW ADDRESS FOR SUBMITTING APPLICATIONS

The application address first provided in Rev. Proc. 97-19 and modified by Notice 2001-62 is no longer correct. Effective May 6, 2015, applications must be submitted to:

Internal Revenue Service
Postal and Transport Policy Section,
PDS
MC 7015 NDAL
4050 Alpha Road
Dallas, TX 75244

The above address is also where a PDS may write to: (1) obtain administrative review of a letter of denial of designation under section 9.03 of Rev. Proc. 97-19; (2) appeal a letter confirming the denial of designation under section 9.06 of Rev. Proc. 97-19; (3) provide prompt written notification to the IRS of any change in application information under

section 10.01 of Rev. Proc. 97-19; and (4) appeal the issuance of a proposed revocation letter under section 12.03 of Rev. Proc. 97-19.

EFFECT ON OTHER DOCUMENTS

Revenue Procedure 97-19 is modified. Notice 97-26, Notice 2001-62, Notice 2002-62 and Notice 2004-83 are superseded.

EFFECTIVE DATE

This notice is effective on May 6, 2015.

FOR FURTHER INFORMATION

The principal author of this notice is Steven L. Karon of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice contact Steven L. Karon at (202) 317-6834 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Application of Modified Carryover Basis to General Basis Rules

REG-107595-11

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the application of the modified carryover basis rules of section 1022 of the Internal Revenue Code (Code). Specifically, the proposed regulations will modify provisions of the Treasury Regulations involving basis rules by including a reference to section 1022 where appropriate. The regulations will affect property transferred from certain decedents who died in 2010. The regulations reflect changes to the law made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

DATES: Written or electronic comments and requests for a public hearing must be received by August 10, 2015.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-107595-11), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-107595-11), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (REG-107595-11).

FOR FURTHER INFORMATION

CONTACT: Concerning the proposed regulations, Mayer R. Samuels, (202) 317-6859; concerning submissions of comments or a request for a public hear-

ing, Oluwafunmilayo Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Subtitle A of title V of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (EGTRRA) enacted section 2210 of the Code, which made chapter 11 (the estate tax) inapplicable to the estate of any decedent who died in 2010. Subtitle E of title V of EGTRRA enacted section 1022 regarding a modified carryover basis system applicable during 2010. On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 (TRUIRJCA) became law, and section 301(a) of TRUIRJCA retroactively reinstated the estate and generation-skipping transfer taxes. However, section 301(c) of TRUIRJCA allows the executor of the estate of a decedent who died in 2010 to elect to apply the Code as though section 301(a) of TRUIRJCA did not apply with respect to chapter 11 and with respect to property acquired or passing from the decedent (within the meaning of section 1014(b) of the Code). Thus, section 301(c) of TRUIRJCA allows the executor of the estate of a decedent who died in 2010 to elect not to have the provisions of chapter 11 apply to the decedent's estate, but rather to have the provisions of section 1022 apply (Section 1022 Election).

Generally, under section 1014(a), the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is the fair market value of the property at the date of the decedent's death. However, if the decedent died in 2010 and the decedent's executor, as defined in section 2203, makes the Section 1022 Election, then the basis of property in the hands of a person acquiring the property from that decedent is governed by section 1022 and not by section 1014.

Section 1022(a)(1) generally provides that property acquired from a decedent (within the meaning of section 1022(e)) is treated as having been transferred by gift. If the decedent's adjusted basis is less

than or equal to the property's fair market value (FMV) determined as of the decedent's date of death, the recipient's basis is the adjusted basis of the decedent. If the decedent's adjusted basis is greater than that FMV, the recipient's basis is limited to that FMV. See section 1022(a)(2).

If the decedent's adjusted basis in the property is less than the property's FMV on the decedent's date of death, sections 1022(b) and 1022(c) allow the executor of a decedent's estate to allocate additional basis (Basis Increase) to certain assets that both are owned by the decedent (within the meaning of section 1022(d)) at death and are acquired from the decedent (within the meaning of section 1022(e)). However, the property's total basis may not exceed the property's FMV on the date of death.

Although section 1022 was applicable only to decedents dying in calendar year 2010, basis determined pursuant to that section will continue to be relevant until all of the property whose basis is determined under that section has been sold or otherwise disposed of. Accordingly, the existing regulations need to be updated to incorporate appropriate references to basis determined under section 1022.

Explanation of Provisions

These proposed regulations incorporate into the existing regulations, as appropriate, references to section 1022 to ensure that references to basis also include basis as determined under that section. Some changes involve simply inserting the words "or section 1022", "and 1022", or similar references. Others (such as § 1.742-1) require the insertion of a new sentence or an example to expressly address the applicability of section 1022. A few changes (such as proposed § 1.684-3) require the inclusion of a new section to provide a detailed explanation of the application of section 1022 in the particular context of the existing regulation. The proposed regulations also provide cross references for section 1022 when appropriate and make other minor, non-substantive changes. Language revisions serve solely to conform the existing regulations to the provisions of section

1022 and no additional changes are intended. The more significant changes are briefly described below.

Section 1.48-12(b)(2)(vii)(B) of the proposed regulations provides that, if a transferee's basis is determined under section 1022, any qualified rehabilitation expenditures incurred by the decedent under section 48 within the measuring period that are treated as having been incurred by the transferee decrease the transferee's basis for purposes of the substantial rehabilitation test.

Section 1.83-4(b)(1) of the proposed regulations provides that, if property to which section 83 applies is acquired by any person while such property is substantially nonvested, such person's basis in the property reflects any adjustments to basis provided under section 1022, as well as under sections 1015 and 1016.

Sections 1.179-4(c)(1)(iv), 1.267(d)-1(a)(3), 1.336-1(b)(5)(i)(A) and 1.355-6(d)(1)(i)(A)(2) of the proposed regulations provide that property acquired from a decedent in a transaction in which the recipient's basis is determined under section 1022 is not acquired by purchase or exchange for purposes of sections 179, 267, 336, and 355(d).

Section 1.197-2(h)(5)(i) of the proposed regulations provides that the anti-churning rules of § 1.197-2(h) do not apply to the acquisition of a section 197(f)(9) intangible if the acquiring taxpayer's basis in the intangible is determined under section 1022.

Section 1.306-3(e) of the proposed regulations provides that section 306 stock continues to be classified as section 306 stock if the basis of such stock is determined by reference to the decedent-stockholder's basis under section 1022. In addition, the revision of the last sentence of the existing regulation clarifies the reference to "the optional valuation date under section 1014" by changing the language to refer expressly to the election to use the alternate valuation date under section 2032.

Section 1.382-9 of the proposed regulations provides that for purposes of § 1.382-9(d)(5)(i), the definition of qualified transfer is expanded to include situations where the transferee's basis in the indebtedness is determined under section 1022.

Section 1.421-2(c)(4) of the proposed regulations provides that an option granted under an employee stock purchase plan acquires a basis, determined under section 1014 (or section 1022, if applicable), only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a).

Section 1.423-2(k)(2) of the proposed regulations provides that if the special rules provided under § 1.423-2(k) are applicable to a share of stock upon the death of an employee, then the basis of the share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014 (or section 1022, if applicable).

Section 1.467-7(c)(2) of the proposed regulations provides that section 467 recapture does not apply to a disposition on death of the transferor if the basis of the property in the hands of the transferee is determined under section 1022. However, section 467 recapture does apply to property that constitutes a right to receive an item of income in respect of a decedent. Section 1.467-7(c)(4) of the proposed regulations provides that, if the transferee subsequently disposes of the property in a transaction to which § 1.467-7(a) applies, the prior understated inclusion is computed by taking into account the amounts attributable to the period of the transferor's ownership of the property prior to the first disposition.

Section 1.617-3(d)(5)(ii)(b) of the proposed regulations provides that the amount of the adjusted exploration expenditures for mining property in the hands of the transferee immediately after a disposition of property that is subject to section 1022 is equal to the amount of the adjusted exploration expenditures for mining property in the hands of the transferor immediately before the disposition, minus the amount of any gain taken into account under section 617(d). In addition, under § 1.617-4(c)(1)(i), no gain is recognized on the gift of mining property. For purposes of determining gain from the disposition of certain mining property, the term "gift" is expanded to include disposition of property with a basis that is determined under section 1022.

Section 684 generally requires gain to be recognized on any transfer of appreci-

ated property by a U.S. person to a foreign non-grantor trust or foreign estate. For decedents dying in 2010, section 684 also applies to certain transfers of property by reason of death to nonresident aliens. Gain is determined by reference to the fair market value of the property over the adjusted basis of such property in the hands of the transferor. Section 1.684-3(c) currently provides that, in the case of a transfer of property by reason of death of a U.S. transferor to a foreign non-grantor trust, no gain recognition is required if the basis of the property in the hands of the trust is determined under section 1014(a).

Section 1.684-3(c) of the proposed regulations provides that this rule is modified to clarify the application of section 684 to transfers of property by reason of death of U.S. transferor decedents dying in 2010. If the executor of a U.S. decedent does not make a Section 1022 Election, the proposed regulations confirm that the general exception to gain recognition will apply. If the executor of a U.S. decedent does make a Section 1022 Election, the proposed regulations provide, consistent with Rev. Proc. 2011-41 (2011-35 IRB 188 (August 29, 2011)) (see § 601.601(d)(2)(ii)(b) of this chapter) and Notice 2011-66 (2011-35 IRB 184 (August 29, 2011)) (see § 601.601(d)(2)(ii)(b) of this chapter), that there is gain recognition. Any basis increase that the executor allocates under section 1022 will reduce the amount of gain in that property for purposes of section 684.

Section 1.742-1(a) of the proposed regulations provides that the basis of a partnership interest acquired from a decedent who died in 2010, and whose executor made a Section 1022 Election, is the lower of the adjusted basis of the decedent or fair market value of the interest at the date of decedent's death. The basis of property acquired from a decedent may be further increased under section 1022(b) and/or 1022(c), but not above the fair market value of the interest on the date of the decedent's death.

Section 1.995-4(d)(2) of the proposed regulations provides that the period during which a shareholder of stock in a DISC has held stock includes the period he is considered to have held it by reason of the application of section 1223 and, if his basis is determined in whole or in part

under the provisions of section 1022, the holding period of the decedent.

Section 1.1014-4(a) of the proposed regulations provides that the basis of property acquired from a decedent, including basis determined under section 1022, is uniform in the hands of every person having possession or enjoyment of the property at any time, whether obtained under the will or other instrument or under the laws of descent and distribution.

Section 1.1014-5(b) of the proposed regulations provides that, in determining gain or loss from the sale or other disposition of a term interest in property the adjusted basis of which is determined pursuant to section 1022, that part of the adjusted uniform basis assignable under the rules of § 1.1014-5(a) to the interest sold or otherwise disposed of is disregarded to the extent and in the manner provided by section 1001(e).

Section 1.1223-1(b) of the proposed regulations provides that the holding period under section 1223 of the recipient of property acquired from a decedent who died in 2010, and whose executor made a Section 1022 Election, includes the period that the property was held by the decedent.

Sections 1.1245-2(c)(2)(ii)(d) and 1.1245-3(a)(3) of the proposed regulations provide that, if section 1245 property is acquired from a decedent who died in 2010 and whose executor made a Section 1022 Election, the amount of the adjustments reflected in the adjusted basis of the property in the hands of the transferee immediately after the transfer is equal to the amount of the adjustments reflected in the adjusted basis of the property in the hands of the transferor immediately before the transfer, minus the amount of any gain taken into account under section 1245(a)(1) by the transferor upon the transfer. Further, even though property is not of a character subject to the allowance for depreciation in the hands of the taxpayer, the property is section 1245 property if the taxpayer's basis in the property is determined under section 1022 and the property was of a character subject to the allowance for depreciation in the hands of the decedent.

Section 1.1245-4(a)(1) of the proposed regulations provides that no gain is recognized under section 1245(a)(1) upon

a transfer of section 1245 property from a decedent whose executor made the Section 1022 Election.

Section 1.1250-4(c)(5) of the proposed regulations provides that the holding period under section 1250(e) for the recipient of property acquired from a decedent who died in 2010, and whose executor made a Section 1022 Election, includes the period that the property was held by the decedent.

Section 1.1254-2(a)(1) of the proposed regulations provides that no gain is recognized under section 1254(a)(1) upon a transfer of natural resource recapture property from a decedent who died in 2010 and whose executor made a Section 1022 Election.

Sections 1.1254-3(b), 1.1254-4(e)(4), and 1.1254-5(c)(2)(iv) of the proposed regulations provide that, for purposes of determining the amount of section 1254 costs from the disposition of natural resource recapture property, the term "gift" is expanded to include the transfer of property with a basis that is determined under section 1022.

Section 1.1296-1(d)(4) of the proposed regulations provides that the basis of stock of a passive foreign investment company for which a section 1296 election was in effect as of the date of the decedent's death that is acquired from a decedent is the lower of the adjusted basis of the stock in the hands of the decedent immediately before his death or the basis that would have been determined under section 1014 or section 1022, as applicable, without regard to this paragraph.

Section 1.1312-7(b) of the proposed regulations provides that the taxpayer with respect to whom the erroneous treatment occurred must be a taxpayer who had title to the property at the time of the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1022.

Proposed Effective/Applicability Date

These regulations are proposed to apply on and after the date the regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. 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 a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its 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 written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available at www.regulations.gov or upon request for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.48-12 is amended by revising the last sentence of paragraph (b)(2)(vii)(B) and adding paragraph (g) to read as follows:

§ 1.48-12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

* * * * *

(b) * * *

(2) * * *

(vii) * * *

(B) * * * If a transferee's basis is determined under section 1014 or section 1022, any expenditures incurred by the decedent within the measuring period that are treated as having been incurred by the transferee under paragraph (c)(3)(ii) of this section shall decrease the transferee's basis for purposes of the substantial rehabilitation test.

* * * * *

(g) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.48-12 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 3. Section 1.83-4 is amended by revising the last sentence of paragraph (b)(1) and adding paragraph (d) to read as follows:

§ 1.83-4 Special rules.

* * * * *

(b) * * *

(1) * * * Such basis shall also reflect any adjustments to basis provided under sections 1015, 1016, and 1022.

* * * * *

(d) *Effective/applicability date.* The provisions in this section are applicable for taxable years beginning on or after July 21, 1978. The provisions of paragraph (b)(1) of this section relating to

section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.179-4 is amended by revising the first sentence of paragraph (c)(1)(iv) to read as follows:

§ 1.179-4 Definitions.

* * * * *

(c) * * *

(1) * * *

(iv) The property is not acquired by purchase if the basis of the property in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, is determined under section 1014(a), relating to property acquired from a decedent, or is determined under section 1022, relating to the basis of property acquired from certain decedents who died in 2010. * * *

* * * * *

Par. 5. Section 1.179-6 is amended by: a. Revising the section heading and the first sentence of paragraph (a).

b. Adding paragraph (d).

The revision and addition read as follows:

§ 1.179-6 Effective/applicability dates.

(a) * * * Except as provided in paragraphs (b), (c), and (d) of this section, the provisions of §§ 1.179-1 through 1.179-5 apply for property placed in service by the taxpayer in taxable years ending after January 25, 1993. * * *

* * * * *

(d) *Application of § 1.179-4(c)(1)(iv).* The provisions of § 1.179-4(c)(1)(iv) relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 6. Section 1.197-2 is amended by revising paragraphs (h)(5)(i) and (h)(12)(viii) and adding paragraph (l)(5) to read as follows:

§ 1.197-2 Amortization of goodwill and certain other intangibles.

* * * * *

(h) * * *

(5) * * *

(i) The acquisition of a section 197(f)(9) intangible if the acquiring taxpayer's basis in the intangible is determined under section 1014(a) or 1022; or * * * * *

(12) * * *

(viii) *Operating rule for transfers upon death.* For purposes of this paragraph (h)(12), if the basis of a partner's interest in a partnership is determined under section 1014(a) or 1022, such partner is treated as acquiring such interest from a person who is not related to such partner, and such interest is treated as having previously been held by a person who is not related to such partner.

* * * * *

(l) * * *

(5) *Application of section 1022.* The provisions of § 1.197-2 relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 7. Section 1.267(d)-1 is amended by revising paragraph (a)(3) to read as follows:

§ 1.267(d)-1 Amount of gain where loss previously disallowed.

(a) * * *

(3) The benefit of the general rule is available only to the original transferee but does not apply to any original transferee (for example, a donee or a person acquiring property from a decedent where the basis of property is determined under section 1014 or 1022) who acquired the property in any manner other than by purchase or exchange.

* * * * *

Par. 8. Section 1.267(d)-2 is amended by revising the section heading and adding a sentence to the end of the paragraph to read as follows:

§ 1.267(d)-2 Effective/applicability dates.

* * * The provisions of § 1.267(d)-1(a)(3) relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 9. Section 1.273-1 is revised to read as follows:

§ 1.273-1 *Life or terminable interests.*

(a) *In general.* Amounts paid as income to the holder of a life or a terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called by depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deduction for shrinkage or exhaustion thereof due to the passage of time. For the treatment generally of distributions to beneficiaries of an estate or trust, see Subparts A, B, C, and D (section 641 and following), Subchapter J, Chapter 1 of the Code, and corresponding regulations. For basis of property acquired from a decedent and by gifts and transfers in trust, see sections 1014, 1015, and 1022, and corresponding regulations.

(b) *Effective/applicability date.* The provisions in this section are applicable for taxable years beginning on or after September 16, 1958. The provisions of this section relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 10. Section 1.306-3 is amended by removing the last sentence of paragraph (e) and adding two sentences in its place to read as follows:

§ 1.306-3 *Section 306 stock defined.*

* * * * *

(e) * * * Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death under section 1014 or the optional valuation date under section 2032. Section 306 stock continues to be so classified if the basis of such stock is determined under section 1022.

* * * * *

Par. 11. Section 1.306-4 is added to read as follows:

§ 1.306-4 *Effective/applicability date.*

The provisions of §§ 1.306-1 through 1.306-3 are applicable on or after June

22, 1954. The provisions of § 1.306-3 relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 12. Section 1.336-1 is amended by revising paragraph (b)(5)(i)(A) to read as follows:

§ 1.336-1 *General principles, nomenclature, and definitions for a section 336(e) election.*

* * * * *

(b) * * *

(5) * * *

(i) * * *

(A) The basis of the stock in the hands of the purchaser is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock is acquired, is not determined under section 1014(a) (relating to property acquired from a decedent), or is not determined under section 1022 (relating to the basis of property acquired from certain decedents who died in 2010);

* * * * *

Par. 13. Section 1.336-5 is amended by revising the section heading and adding a sentence to the end of the paragraph to read as follows:

§ 1.336-5 *Effective/applicability dates.*

* * * The provisions of § 1.336-1(b)(5)(i)(A) relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 14. Section 1.355-6 is amended by revising paragraphs (d)(1)(i)(A)(2) and (g) to read as follows:

§ 1.355-6 *Recognition of gain on certain distributions of stock or securities in controlled corporation.*

* * * * *

(d) * * *

(1) * * *

(i) * * *

(A) * * *

(2) Under section 1014(a) or 1022; and * * * * *

(g) *Effective/applicability dates.* This section applies to distributions occurring

after December 20, 2000, except that they do not apply to any distributions occurring pursuant to a written agreement that is (subject to customary conditions) binding on December 20, 2000, and at all later times. The provisions of paragraph (d)(1)(i)(A)(2) of this section relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 15. Section 1.382-9 is amended by revising paragraphs (d)(5)(ii)(D) and (d)(6)(i) to read as follows:

§ 1.382-9 *Special rules under section 382 for corporations under the jurisdiction of a court in a title 11 or similar case.*

* * * * *

(d) * * *

(5) * * *

(ii) * * *

(D) The transferee's basis in the indebtedness is determined under section 1014, 1015, or 1022 or with reference to the transferor's basis in the indebtedness; * * * * *

(6) *Effective/applicability date*—(i) *In general.* This paragraph (d) applies to ownership changes occurring on or after March 17, 1994. The provisions of paragraph (d)(5)(ii)(D) of this section relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 16. Section 1.421-2 is amended by:

a. Revising paragraphs (c)(4)(i)(a) and (c)(4)(ii).

b. Revising paragraph (f) heading and adding paragraph (f)(3).

The revisions and addition read as follows:

§ 1.421-2 *General rules.*

* * * * *

(c) * * *

(4)(i)(a) In the case of the death of an optionee, the basis of any share of stock acquired by the exercise of an option under this paragraph (c), determined under section 1011, shall be increased by an

amount equal to the portion of the basis of the option attributable to such share. For example, if a statutory option to acquire 10 shares of stock has a basis of \$100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10th of \$100, or \$10. The option acquires a basis, determined under section 1014(a) or under section 1022, if applicable, only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). To the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value (or the basis as determined under section 1022, if applicable) at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by paragraphs (c)(4)(i)(b) and (c) of this section, but such adjustments are only applicable in the case of an option that is subject to section 423(c).

* * * * *

(ii) If a statutory option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property that constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) (or section 1022(f), if applicable) apply.

* * * * *

(f) *Effective/applicability date.* * * *

* * * * *

(3) *Application of section 1022.* The provisions of § 1.421-2(c) relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 17. Section 1.423-2 is amended by:

a. Revising the third sentence of paragraph (k)(2).

b. Adding a sentence to the end of paragraph (l).

The revision and addition read as follows:

§ 1.423-2 Employee stock purchase plan defined.

* * * * *

(k) * * *

(2) * * * If the special rules provided in this paragraph (k) are applicable to a share of stock upon the death of an employee, then the basis of the share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014 or under section 1022, if applicable, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in the decedent's gross income under this paragraph (k). * * *

* * * * *

(1) * * * The provisions of § 1.423-2 relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 18. Section 1.424-1 is amended by revising the last sentence of paragraph (c)(2) and adding paragraph (g)(3) to read as follows:

§ 1.424-1 Definitions and special rules applicable to statutory options.

* * * * *

(c) * * *

(2) * * * For determination of basis in the hands of the survivor where joint ownership is terminated by the death of one of the owners, see section 1014 or section 1022, if applicable.

* * * * *

(g) * * *

(3) *Application of section 1022.* The provisions of § 1.424-1(c)(2) relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 19. Section 1.467-7 is amended by revising paragraph (c)(2) and revising the first sentence of paragraph (c)(4) to read as follows:

§ 1.467-7 Section 467 recapture and other rules relating to dispositions and modifications.

* * * * *

(c) * * *

(2) *Dispositions at death.* Paragraph (a) of this section does not apply to a dispo-

sition if the basis of the property in the hands of the transferee is determined under section 1014(a) or section 1022. However, see paragraph (c)(4) of this section for dispositions of property subject to section 1022 by transferees. This paragraph (c)(2) does not apply to property that constitutes a right to receive an item of income in respect of a decedent. See sections 691, 1014(c), and 1022(f).

* * * * *

(4) * * * If the recapture amount with respect to a disposition of property (the first disposition) is limited under paragraph (c)(1), (c)(2) (if the basis of the property in the hands of the transferee is determined under section 1022), or (c)(3) of this section and the transferee subsequently disposes of the property in a transaction to which paragraph (a) of this section applies, the prior understated inclusion determined under paragraph (b)(2) of this section is computed by taking into account the amounts attributable to the period of the transferor's ownership of the property prior to the first disposition. * * *

* * * * *

Par. 20. Section 1.467-9 is amended by revising the section heading and adding paragraph (f) to read as follows:

§ 1.467-9 Effective/applicability dates and automatic method changes for certain agreements.

* * * * *

(f) *Application of section 1022.* The provisions of § 1.467-7(c) relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 21. Section 1.617-3 is amended by revising paragraph (d)(5)(ii)(b) to read as follows:

§ 1.617-3 Recapture of exploration expenditures.

* * * * *

(d) * * *

(5) * * *

(ii) * * *

(b) The transactions referred to in paragraph (d)(5)(ii)(a) of this section are:

(1) A disposition that is in part a sale or exchange and in part a gift;

(2) A disposition that is described in section 617(d) through the incorporation by reference of the provisions of section 1245(b)(3) (relating to certain tax free transactions); or

(3) A transfer at death where basis of property in the hands of the transferee is determined under section 1022.

* * * * *

Par. 22. Section 1.617-4 is amended by revising the second sentence of paragraph (c)(1)(i) to read as follows:

§ 1.617-4 Treatment of gain from disposition of certain mining property.

* * * * *

(c) * * *

(1)(i) * * * For purposes of this paragraph (c), the term “gift” means, except to the extent that paragraph (c)(1)(ii) of this section applies, a transfer of mining property that, in the hands of the transferee, has a basis determined under the provisions of section 1015(a) or 1015(d) (relating to basis of property acquired by gift) or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010). * * *

* * * * *

Par. 23. Section 1.617-5 is added to read as follows:

§ 1.617-5 Effective/applicability date.

Sections 1.617-3 and 1.617-4 apply on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see §§ 1.617-3 and 1.617-4 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 24. Section 1.684-3 is amended by revising paragraph (c) to read as follows:

§ 1.684-3 Exceptions to general rule of gain recognition.

* * * * *

(c) *Certain transfers at death*—(1) *Section 1014 basis*. The general rule of gain recognition under § 1.684-1 shall not apply to any transfer of property to a foreign

trust or foreign estate or, in the case of a transfer of property by a U.S. transferor decedent dying in 2010, to a foreign trust, foreign estate, or a nonresident alien, by reason of death of the U.S. transferor, if the basis of the property in the hands of the transferee is determined under section 1014(a).

(2) *Section 1022 basis election*. For U.S. transferor decedents dying in 2010, the general rule of gain recognition under § 1.684-1 shall apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust, foreign estate, or the nonresident alien individual is determined under section 1022. The gain on the transfer shall be calculated as set out under § 1.684-1(a), except that adjusted basis will reflect any increases allocated to such property under section 1022.

* * * * *

Par. 25. Section 1.684-5 is revised to read as follows:

§ 1.684-5 Effective/applicability dates.

(a) Sections 1.684-1 through 1.684-4 apply to transfers of property to foreign trusts and foreign estates after August 7, 2000, except as provided in paragraph (b) of this section.

(b) In the case a U.S. transferor decedent dying in 2010, § 1.684-3(c) applies to transfers of property to foreign trusts, foreign estates, and nonresident aliens after December 31, 2009, and before January 1, 2011.

Par. 26. Section 1.691(a)-3 is amended by revising the last two sentences of paragraph (a) and adding paragraph (c) to read as follows:

§ 1.691(a)-3 Character of gross income.

(a) * * * The provisions of section 1014(a), relating to the basis of property acquired from a decedent, and section 1022, relating to the basis of property acquired from certain decedents who died in 2010, do not apply to these amounts in the hands of the estate and such persons. See sections 1014(c) and 1022(f).

* * * * *

(c) *Effective/applicability dates*. The last two sentences of paragraph (a) of this

section apply on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.691(a)-3 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 27. Section 1.742-1 is revised to read as follows:

§ 1.742-1 Basis of transferee partner's interest.

(a) *In general*. The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), Subchapter O, Chapter 1 of the Internal Revenue Code. Thus, the basis of a purchased interest will be its cost. Generally, the basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and §§ 1.706-1(c)(3)(v) and 1.753-1(b)) under section 691. See section 1014(c). However, the basis of a partnership interest acquired from a decedent is determined under section 1022 if the decedent died in 2010 and the decedent's executor elected to have section 1022 apply to the decedent's estate. For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

(b) *Effective/applicability date*. This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.742-1 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 28. Section 1.743-1 is amended by revising paragraphs (k)(2)(ii) and (l) to read as follows:

§ 1.743-1 *Optional adjustment to basis of partnership property.*

* * * * *
(k) * * *
(2) * * *

(ii) *Special rule.* A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner's date of death, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014 or section 1022, the manner in which the fair market value of the partnership interest was determined, and the carryover basis as adjusted under section 1022 (if applicable).

* * * * *

(l) *Effective/applicability date.* The provisions in this section apply to transfers of partnership interests that occur on or after December 15, 1999. The provisions of this section relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 29. Section 1.755-1 is amended by:

- a. Revising paragraphs (a)(4)(i)(C) and the first sentence of (b)(4)(i).
- b. Revising the heading of paragraph (e) and paragraph (e)(2).

The revisions read as follows:

§ 1.755-1 *Rules for allocation of basis.*

(a) * * *
(4) * * *
(i) * * *

(C) *Income in respect of a decedent.* Solely for the purpose of determining partnership gross value under this paragraph (a)(4)(i), where a partnership inter-

est is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to section 1014(c) or section 1022(f), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691.

* * * * *
(b) * * *
(4) * * *

(i) * * * Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) or section 1022(f), the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691. * * *

* * * * *

(e) *Effective/applicability dates.* * * *

(2) *Special rules.* Paragraphs (a) and (b)(3)(iii) of this section apply to transfers of partnership interests and distributions of property from a partnership that occur on or after June 9, 2003. The provisions of paragraphs (a)(4)(i)(C) and (b)(4)(i) of this section relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 30. Section 1.995-4 is amended by revising the first sentence of paragraph (d)(2) and adding paragraph (f) to read as follows:

§ 1.995-4 *Gain on disposition of stock in a DISC.*

* * * * *
(d) * * *

(2) * * * For purposes of this section, the period during which a shareholder has held stock includes the period he is considered to have held it by reason of the application of section 1223 and, if his basis is determined in whole or in part under the provisions of section 1014(d) (relating to special rule for DISC stock acquired from decedent) or section 1022 (relating to property acquired from certain decedents who died in 2010), the holding period of the decedent. * * *

* * * * *

(f) *Effective/applicability date.* This section applies on and after the date these

regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.995-4 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 31. Section 1.1001-1 is amended by revising the last sentence of paragraph (a), revising paragraph (f)(1), and adding paragraph (f)(5) to read as follows:

§ 1.1001-1 *Computation of gain or loss.*

(a) * * * Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

* * * * *

(f) * * *

(1) *General rule.* Except as otherwise provided in paragraph (f)(3) of this section, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of this section), a taxpayer shall not take into account that portion of the adjusted basis of such interest that is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest:

(i) Is determined pursuant to sections 1014, 1015, or 1022; and

(ii) Is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph (f) to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See paragraph (f)(2) of this section for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies. That portion of the adjusted uniform basis of the entire property that is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest that is not a portion of the adjusted uniform basis of the entire property.

* * * * *

(5) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1001-1 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

* * * * *

Par.32. Section 1.1014-1 is amended by revising paragraph (a) and adding paragraph (d) to read as follows:

§ 1.1014-1 Basis of property acquired from a decedent.

(a) *General rule.* The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date pre-

scribed in section 2032, or in section 811(j) of the Internal Revenue Code (Code) of 1939. However, the basis of property acquired from certain decedents who died in 2010 is determined under section 1022, if the decedent's executor made an election under section 301(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 (124 Stat. 3296, 3300 (2010)). See section 1022. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Code of 1954 or the Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see § 1.1014-3(e).

* * * * *

(d) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1014-1 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 33. Section 1.1014-4 is amended by revising the first sentence of paragraph (a)(1), revising the second sentence of paragraph (a)(2), and adding paragraph (d) to read as follows:

§ 1.1014-4 Uniformity of basis; adjustment to basis.

(a) * * *

(1) The basis of property acquired from a decedent, as determined under section 1014(a) or section 1022, is uniform in the

hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. * * *

(2) * * * Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of section 1014 or section 1022, and, for this reason, a common or uniform basis for all such interests. * * *

* * * * *

(d) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1014-4 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 34. Section 1.1014-5 is amended by revising paragraph (b), adding and reserving paragraph (d), and adding paragraph (e) to read as follows:

§ 1.1014-5 Gain or loss.

* * * * *

(b) *Sale or other disposition of certain term interests.* In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f).

* * * * *

(d) [Reserved]

(e) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal**

Register, see § 1.1014–5 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 35. Section 1.1223–1 is amended by adding a sentence to the end of paragraph (b) and adding paragraph (l) to read as follows:

§ 1.1223–1 Determination of period for which capital assets are held.

* * * * *

(b) * * * Similarly, the period for which property acquired from a decedent who died in 2010 was held by the decedent must be included in determining the period during which the property was held by the recipient, if the recipient’s basis in the property is determined under section 1022.

* * * * *

(l) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**, see § 1.1223–1 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 36. Section 1.1245–2 is amended by revising paragraph (c)(2)(ii) and adding paragraph (d) to read as follows:

§ 1.1245–2 Definition of recomputed basis.

* * * * *

(c) * * *

(2) * * *

(ii) The transactions referred to in paragraph (c)(2)(i) of this section are:

(a) A disposition that is in part a sale or exchange and in part a gift (see § 1.1245–4(a)(3));

(b) A disposition (other than a disposition to which section 1245(b)(6)(A) applies) that is described in section 1245(b)(3) (relating to certain tax-free transactions);

(c) An exchange described in § 1.1245–4(e)(2) (relating to transfers described in section 1081(d)(1)(A)); or

(d) A transfer at death where the basis of property in the hands of the transferee is determined under section 1022.

* * * * *

(d) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**, see § 1.1245–2 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 37. Section 1.1245–3 is amended by revising paragraph (a)(3) and adding paragraph (d) to read as follows:

§ 1.1245–3 Definition of section 1245 property.

(a) * * *

(3) Even though property may not be of a character subject to the allowance for depreciation in the hands of the taxpayer, such property may nevertheless be section 1245 property if the taxpayer’s basis for the property is determined by reference to its basis in the hands of a prior owner of the property and such property was of a character subject to the allowance for depreciation in the hands of such prior owner, or if the taxpayer’s basis for the property is determined by reference to the basis of other property that in the hands of the taxpayer was property of a character subject to the allowance for depreciation, or if the taxpayer’s basis for the property is determined under section 1022 and such property was of a character subject to the allowance for depreciation in the hands of the decedent. Thus, for example, if a father uses an automobile in his trade or business during a period after December 31, 1961, and then gives the automobile to his son as a gift for the son’s personal use, the automobile is section 1245 property in the hands of the son.

* * * * *

(d) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1245–3 as contained in

26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 38. Section 1.1245–4 is amended by revising the second sentence of paragraph (a)(1) and adding paragraph (i) to read as follows:

§ 1.1245–4 Exceptions and Limitations.

(a) * * *

(1) * * * For purposes of this paragraph (a), the term “gift” means, except to the extent that paragraph (a)(3) of this section applies, a transfer of property that, in the hands of the transferee, has a basis determined under the provisions of section 1015(a) or 1015(d) (relating to basis of property acquired by gifts) or section 1022 (relating to basis of property acquired from certain decedents who died in 2010).

* * * * *

(i) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1245–4 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

Par. 39. Section 1.1250–4 is amended by adding paragraphs (c)(5) and (h) to read as follows:

§ 1.1250–4 Holding period.

* * * * *

(c) * * *

(5) A transfer at death where the basis of the property in the hands of the transferee is determined under section 1022.

* * * * *

(h) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1250–4 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are pub-

lished as final regulations in the **Federal Register**).

Par. 40. Section 1.1254-2 is amended by revising the second sentence of paragraph (a)(1) to read as follows:

§ 1.1254-2 *Exceptions and limitations.*

(a) * * *

(1) * * * For purposes of this paragraph (a), the term “gift” means, except to the extent that paragraph (a)(2) of this section applies, a transfer of natural resource recapture property that, in the hands of the transferee, has a basis determined under the provisions of section 1015(a) or 1015(d) (relating to basis of property acquired by gift) or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010). * * *

* * * * *

Par. 41. Section 1.1254-3 is amended by revising paragraphs (b)(2)(ii) and (iii) and adding paragraph (b)(2)(iv) to read as follows:

§ 1.1254-3 *Section 1254 costs immediately after certain acquisitions.*

* * * * *

(b) * * *

(2) * * *

(ii) A transaction described in section 1041(a);

(iii) A disposition described in § 1.1254-2(c)(3) (relating to certain tax-free transactions); or

(iv) A transfer at death where basis of property in the hands of the transferee is determined under section 1022.

* * * * *

Par. 42. Section 1.1254-4 is amended by revising paragraph (e)(4) introductory text to read as follows:

§ 1.1254-4 *Special rules for S corporations and their shareholders.*

* * * * *

(e) * * *

(4) * * * If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, in a transfer that is described in section 1041(a), or in a transfer at death where the basis of property in the hands of the transferee is determined under section 1022, the amount of section 1254 costs with

respect to the property held by the corporation in the acquiring shareholder’s hands immediately after the transfer is an amount equal to—

* * * * *

Par. 43. Section 1.1254-5 is amended by revising paragraph (c)(2)(iv) introductory text to read as follows:

§ 1.1254-5 *Special rules for partnerships and their partners.*

* * * * *

(c) * * *

(2) * * *

(iv) * * * If an interest in a partnership is transferred in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, in a transfer that is described in section 1041(a), or in a transfer at death where the basis of property in the hands of the transferee is determined under section 1022, the amount of the transferee partner’s section 1254 costs with respect to property held by the partnership immediately after the transfer is an amount equal to—

* * * * *

Par. 44. Section 1.1254-6 is revised to read as follows:

§ 1.1254-6 *Effective/applicability date.*

(a) Sections 1.1254-1 through 1.1254-3 and 1.1254-5 are effective with respect to any disposition of natural resource recapture property occurring after March 13, 1995. The rule in § 1.1254-1(b)(2)(iv)(A)(2), relating to a nonoperating mineral interest carved out of an operating mineral interest with respect to which an expenditure has been deducted, is effective with respect to any disposition occurring after March 13, 1995, of property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986. Section 1.1254-4 applies to dispositions of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and dispositions of S corporation stock occurring on or after October 10, 1996. Sections 1.1254-2(d)(1)(ii), 1.1254-3(b)(1)(i), (b)(1)(ii), (d)(1)(i), and (d)(1)(ii) are effective for dispositions

of property occurring on or after October 10, 1996.

(b) The provisions of §§ 1.1254-2(a)(1), 1.1254-3(b)(2), 1.1254-4(e)(4), and 1.1254-5(c)(2)(iv) that relate to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 45. Section 1.1296-1 is amended by revising paragraphs (d)(4) and (j) to read as follows:

§ 1.1296-1 *Mark to market election for marketable stock.*

* * * * *

(d) * * *

(4) *Stock acquired from a decedent.* In the case of stock of a PFIC that is acquired by bequest, devise, or inheritance (or by the decedent’s estate) and with respect to which a section 1296 election was in effect as of the date of the decedent’s death, notwithstanding section 1014 or section 1022, the basis of such stock in the hands of the person so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis that would have been determined under section 1014 or section 1022 without regard to this paragraph (d)).

* * * * *

(j) *Effective/applicability date.* The provisions in this section are applicable for taxable years beginning on or after May 3, 2004. The provisions of paragraph (d)(4) of this section relating to section 1022 are effective on and after the date these regulations are published as final regulations in the **Federal Register**.

Par. 46. Section 1.1312-7 is amended by revising paragraph (b) and adding paragraph (d) to read as follows:

§ 1.1312-7 *Basis of property after erroneous treatment of a prior transaction.*

* * * * *

(b)(1) For this section to apply, the taxpayer with respect to whom the erroneous treatment occurred must be:

(i) The taxpayer with respect to whom the determination is made; or

(ii) A taxpayer who acquired title to the property in the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title in such a manner that he will have a basis ascertained by reference to the basis in the hands of the taxpayer who acquired title to the property in the erroneously treated transaction; or

(iii) A taxpayer who had title to the property at the time of the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift) or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

(2) No adjustment is authorized with respect to the transferor of the property in a transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of the original transferee.

* * * * *

(d) *Effective/applicability date.* This section applies on and after the date these regulations are published as final regulations in the **Federal Register**. For rules before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1312-7 as contained in 26 CFR (revised as of the April 1 preceding the date these regulations are published as final regulations in the **Federal Register**).

John Dalrymple,
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on May 8, 2015, 8:45 a.m., and published in the issue of the Federal Register for May 11, 2015, 80 F.R. 26873)

Notice of Proposed Rulemaking

Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources

REG-132634-14

AGENCY: Internal Revenue Service (IRS),
Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 7704(d)(1)(E) of the Internal Revenue Code (Code) relating to qualifying income from exploration, development, mining or production, processing, refining, transportation, and marketing of minerals or natural resources. The proposed regulations affect publicly traded partnerships and their partners.

DATES: Comments and requests for a public hearing must be received by August 4, 2015.

ADDRESSES: Send submissions to: CC: PA:LPD:PR (REG-132634-14), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-132634-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-132634-14).

FOR FURTHER INFORMATION

CONTACT: Concerning the proposed regulations, Caroline E. Hay at (202) 317-5279; concerning the submissions of comments and requests for a public hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regula-

tions (26 CFR part 1) under section 7704(d)(1)(E) regarding qualifying income from certain activities with respect to minerals or natural resources.

Congress enacted section 7704 in the Omnibus Budget Reconciliation Act of 1987, Public Law 100-203 (101 Stat. 1330 (1987)), due to concerns that the rapid growth of certain publicly traded partnerships was eroding the corporate tax base. See H.R. Rep. No. 100-391, at 1065 (1987). Section 7704(a) provides that, as a general rule, publicly traded partnerships will be treated as corporations. In section 7704(c), Congress provided an exception from this rule if 90 percent or more of the partnership's gross income is "qualifying income." Qualifying income is generally passive-type income, such as interest, dividends, and rent. Section 7704(d)(1)(E) provides, however, that qualifying income also includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or marketing of minerals or natural resources. Section 7704(d)(1) defines the term "mineral or natural resource" as any product for which a deduction for depletion is allowed under section 611, except soil, sod, dirt, turf, water, mosses, or minerals from sea water, the air, or other similar inexhaustible sources.

Regulations have been published providing guidance on (1) when a partnership is publicly traded (§ 1.7704-1), (2) transition rules for partnerships in existence prior to the effective date of section 7704 (§ 1.7704-2), and (3) qualifying income from certain financial products (§ 1.7704-3). No regulations have been issued under section 7704(d)(1)(E). Instead, questions about the specific application of section 7704(d)(1)(E) generally have been resolved by private letter ruling. However, the number of private letter ruling requests received has increased steadily from five or fewer requests per year for most years before 2008 to more than 30 requests received in 2013. Many of these requests seek rulings that income from support services provided to businesses engaged in the section 7704(d)(1)(E) activities is qualifying income for purposes of section 7704. The Treasury Department and the IRS are issuing these proposed regulations in response to this increased

interest in the application of section 7704(d)(1)(E).

These proposed regulations provide guidance on whether income from activities with respect to minerals or natural resources as defined in section 7704(d)(1) is qualifying income. These regulations do not address the transportation or storage of any fuel described in section 6426(b), (c), (d) or (e), or activities with respect to industrial source carbon dioxide, any alcohol fuel defined in section 6426(b)(4)(A), or any biodiesel fuel as defined in section 40A(d)(1). The Treasury Department and the IRS request comments concerning whether guidance is also needed with respect to those activities and, if so, the specific issues such guidance should address.

Explanation of Provisions

These proposed regulations use the term “qualifying activities” to describe activities relating to minerals or natural resources that generate qualifying income. Qualifying activities include: (1) the exploration, development, mining or production, processing, refining, transportation, or marketing of minerals or natural resources (section 7704(d)(1)(E) activities), and (2) certain limited support activities that are intrinsic to section 7704(d)(1)(E) activities (an “intrinsic activity”). These proposed regulations set forth the requirements under which an activity is a qualifying activity.

1. Section 7704(d)(1)(E) activities

Section 7704(d)(1)(E) activities represent different stages in the extraction of minerals or natural resources and the eventual offering of products for sale. These stages include exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), and marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). Each of these stages involves various types of operations. Based in part on discussions with IRS engineers specializing in the various oil and natural resource fields, the proposed regulations provide an exclusive list of operations that comprise the section 7704(d)(1)(E) activities for purposes of section 7704. This list may be expanded

by published guidance. The Treasury Department and the IRS intend that this list represents only those activities that would be undertaken by an exploration and development company, a mining or production company, a refiner or processor, or a transporter or marketer of a mineral or natural resource. Services provided to those businesses are not section 7704(d)(1)(E) activities, although they may qualify as intrinsic activities. The Treasury Department and the IRS request comments concerning whether additional activities should be included in the list of section 7704(d)(1)(E) activities.

A. Exploration

These proposed regulations define exploration as an activity performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit. A partnership is engaged in exploration if the partnership: (i) drills an exploratory or stratigraphic type test well; (ii) conducts drill stem and production flow tests to verify commerciality of the deposit; (iii) conducts geological or geophysical surveys; or (iv) interprets data obtained from geological or geophysical surveys. For minerals, exploration also includes testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146) if conducted prior to development activities with respect to the minerals.

B. Development

These proposed regulations define development as an activity performed to make minerals or natural resources accessible. A partnership is engaged in development if the partnership: (i) drills wells to access deposits of mineral or natural resources; (ii) constructs and installs drilling, production, or dual purpose platforms in marine locations (or constructs and installs any similar supporting structures necessary for extraordinary non-marine terrain such as swamps or tundra); (iii) completes wells including by installing lease and well equipment (such as pumps, flow lines, separators, and storage tanks) so that wells are capable of produc-

ing oil and gas, and the production can be removed from the premises; (iv) performs a development technique (for example, fracturing for oil and natural gas, or, with respect to minerals, stripping, benching and terracing, dredging by dragline, stoping, and caving or room-and-pillar excavation); or (v) constructs and installs gathering systems and custody transfer stations.

C. Mining or production

These proposed regulations define mining or production as an activity performed to extract minerals or other natural resources from the ground. A partnership is engaged in mining or production if the partnership: (i) operates equipment to extract natural resources from mines or wells, or (ii) operates equipment to convert raw mined products or raw well effluent to substances that can be readily transported or stored (including by passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water).

D. Processing or refining

Because processing and refining activities vary with respect to different minerals or natural resources, these proposed regulations provide industry-specific rules (described herein) for when an activity qualifies as processing or refining. In general, however, these proposed regulations provide that an activity is processing or refining if it is done to purify, separate, or eliminate impurities. These proposed regulations further require that, for an activity to be treated as processing or refining, the partnership's position that an activity is processing or refining for purposes of section 7704 must be consistent with the partnership's designation of an appropriate Modified Accelerated Cost Recovery System (MACRS) class life for assets used in the activity in accordance with Rev. Proc. 87-56 (1987-2 CB 674) (for example, MACRS asset class 13.3 for petroleum refining facilities). In addition, except as specifically provided otherwise, process-

ing or refining does not include activities that cause a substantial physical or chemical change in a mineral or natural resource, or that transform the extracted mineral or natural resource into new or different mineral products, including manufactured products. The Treasury Department and the IRS believe that this rule is consistent with definitions found elsewhere in the Code and regulations. See, for example, § 1.613-4(g)(5).

With respect to natural gas, an activity is processing or refining only if the activity purifies natural gas, including by removal of oil or condensate, water, and non-hydrocarbon gases (including carbon dioxide, hydrogen sulfide, nitrogen, and helium), or separates natural gas into its constituents which are normally recovered in a gaseous phase (for example, methane and ethane) and those which are normally recovered in a liquid phase (for example, propane and butane, pentane and gas condensate). It is generally anticipated that activities that create the products listed in the 2012 version (the most recent version as of the date of publication of these proposed regulations) of North American Industry Classification System (NAICS) code 211112 concerning natural gas liquid extraction will be qualifying activities. Processing will also include converting methane in one integrated conversion into liquid fuels that are otherwise produced from the processing of crude oil, as described in the following paragraph.

With respect to crude oil, an activity is processing or refining if the activity is performed to physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes, and similar products. An activity that chemically converts the physically separated components is processing or refining of crude oil only if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost-effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline). It is generally anticipated that activities within a refinery that create the products that are listed in the 2012 version (the most recent version

as of the date of publication of these proposed regulations) of NAICS code 324110 concerning petroleum refineries will be qualifying activities, if those products are refinery grade products that are obtained in the steps required to make fuels, lubricating base oils, waxes, and similar products. Additionally, physically separating any product that is itself generated by the processing or refining of crude oil is a qualifying activity for purposes of section 7704(d)(1)(E).

The production of plastics and similar petroleum derivatives does not give rise to qualifying income derived from processing or refining. See H.R. Rep. No. 100-495, at 947 (1987) (Conf. Rep.). The following products are also not qualifying products under this standard: (1) heat, steam, or electricity produced by the refining processes; (2) products that are obtained from third parties or produced on-site for use in the refinery, such as hydrogen, if excess amounts are sold; and (3) any product that results from further chemical change of the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil (for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as to anode-grade coke) does not qualify because it is further chemically changed).

With respect to ores and minerals, an activity is processing or refining if the activity is listed in Treas. Reg. § 1.613-4(f)(1)(ii) or (g)(6)(iii). Generally, refining of ores and minerals is any activity that eliminates impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as for example, the refining of blister copper.

With respect to timber, an activity is processing if it merely modifies the physical form of timber. Processing includes the application of heat or pressure to timber without adding any foreign substances. Processing of timber does not include activities that use chemicals or other foreign substances to manipulate timber's physical or chemical properties, such as using a digester to produce pulp. Products that result from timber processing include wood chips, sawdust, untreated lumber, veneers (unless a foreign substance is

added), wood pellets, wood bark, and rough poles. Products that are not the result of timber processing include pulp, paper, paper products, treated lumber, oriented strand board, plywood, and treated poles.

These proposed regulations reserve the provisions relating to fertilizer. The Treasury Department and the IRS request comments on what activities should be included.

E. Transportation

These proposed regulations define transportation as the movement of minerals or natural resources and products produced from processing and refining, including by pipeline, barge, rail, or truck. Transportation also includes terminalling, providing storage services, and operating custody transfer stations and gathering systems. Transportation includes the construction of a pipeline only to the extent that a pipe is run to connect a client to a preexisting interstate or intrastate line owned by the publicly traded partnership (interconnect agreement). Transportation (except for pipeline transportation) does not include transportation of oil or gas (or oil or gas products) to a place that sells or dispenses to retail customers. See H.R. Rep. No. 100-795, at 401 (1988). The legislative history accompanying section 7704 clarifies that "a retail customer does not include a person who acquires the oil or gas for refining or processing, or partially refined or processed products thereof for further refining or processing, . . . [or a] utility providing power to customers." See H.R. Rep. No. 100-1104, vol. 2, at 18 (1988) (Conf. Rep.). By contrast, "transporting refined petroleum products by truck to retail customers is not a qualifying activity." *Id.* However, transportation includes bulk transportation, so long as the transportation is not to a place that sells or dispenses oil and gas (or oil and gas products) to retail customers. See S. Rep. No. 100-445, at 424 (1988).

F. Marketing

These proposed regulations define marketing as the activities undertaken to facilitate sale of minerals or natural resources, or products produced from pro-

cessing and refining. Marketing may also include some additive blending into fuels provided to a customer's specification. The legislative history of section 7704 provides that marketing does not include activities and assets involved primarily in sales "to end users at the retail level." S. Rep. No. 100-445, at 424 (1988). Therefore, marketing does not include retail sales (sales made in small quantities directly to end users). For example, gas station operations are not included in marketing for purposes of section 7704(d)(1)(E). *Id.* However, marketing includes bulk and wholesale sales made to end users. See, for example, H.R. Rep. 100-1104, at 18 (1988) (Conf. Rep.) (with respect to fertilizer) and incorporating in footnote 1, 133 Cong. Rec. 37957 (December 22, 1987) (statement of Sen. Bentsen with respect to propane).

2. *Intrinsic Activities*

The Treasury Department and the IRS believe that certain limited support activities intrinsic to section 7704(d)(1)(E) activities also give rise to qualifying income because the income is "derived from" the section 7704(d)(1)(E) activities. The proposed regulations set forth three requirements for a support activity to be intrinsic to section 7704(d)(1)(E) activities. An activity will qualify as an intrinsic activity only if the activity is specialized to support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. If each of these requirements is met, the activity is an intrinsic activity, and any income received from the activity is qualifying income. The Treasury Department and IRS intend that intrinsic activities constitute active support of section 7704(d)(1)(E) activities, and not merely the supply of goods.

A. Specialized

An activity meets the first requirement of the intrinsic test if both the personnel performing the activity and any property used in the activity or sold to the customer performing the section 7704(d)(1)(E) ac-

tivity are specialized. Personnel are specialized if they have received training unique to the mineral or natural resource industries that is of limited utility other than to perform or support a section 7704(d)(1)(E) activity. An activity cannot be an intrinsic activity without specialized service personnel because all intrinsic activities require the provision of significant services (as described in part 3.C of the Explanation of Provisions section of this Preamble). For example, catering services provided to employees at a drilling site would not give rise to qualifying income because catering services do not require skills (or equipment as explained below) limited to supporting a section 7704(d)(1)(E) activity. As such, catering services are not intrinsic activities and any income from those services is not qualifying income for purposes of section 7704(c).

If an activity also involves the sale, provision, or use of property, then the property must qualify as specialized for the activity to be an intrinsic activity. The proposed regulations provide two alternative tests under which that property can qualify as specialized. Under the first test, property is specialized if it is used only in connection with section 7704(d)(1)(E) activities and has limited use outside of those activities. That property must also not be easily converted to a use other than performing or supporting a section 7704(d)(1)(E) activity. Whether property is easily converted is determined based on all facts and circumstances, including the cost to convert the property.

Under the second test, property that can be used for purposes other than to perform or support a section 7704(d)(1)(E) activity will qualify as specialized to the extent that the property is used as an injectant to perform a section 7704(d)(1)(E) activity, and, as part of the activity, the partnership also collects and cleans, recycles, or otherwise disposes of the injectant after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities. Injectants under this definition include, for example, water, lubricants, and sand used in connection with section 7704(d)(1)(E) activities.

B. Essential

An activity meets the second requirement of the intrinsic test if the activity is essential to a section 7704(d)(1)(E) activity. An activity is essential if it is necessary to (a) physically complete the section 7704(d)(1)(E) activity (including in a cost effective manner in order to make the activity economically viable), or (b) comply with federal, state or local law regulating the section 7704(d)(1)(E) activity. For example, water delivery and disposal services are essential when provided for use in fracturing because the water must be used to complete the drilling operations (a development activity under section 7704(d)(1)(E)) and because the water disposal services must be performed to comply with federal, state, or local law regulating drilling and fracturing. Legal, financial, consulting, accounting, insurance, and other similar services are not essential to a section 7704(d)(1)(E) activity because the connection to completion of the section 7704(d)(1)(E) activity is too attenuated.

C. Significant Services

An activity meets the third requirement of the intrinsic test if the activity includes the provision of significant services. A partnership provides significant services if its personnel have an ongoing or frequent presence at the site of the section 7704(d)(1)(E) activity and the activities of those personnel are necessary for the partnership to provide its services or to support the section 7704(d)(1)(E) activity. A partnership that provides the same services to multiple clients may satisfy this test by performing the activity through a rotating presence at multiple sites. For this purpose, determining whether services are ongoing or frequent is determined under all facts and circumstances, including recognized best practices in the relevant industry. The Treasury Department and the IRS request comments on whether and how this requirement could be set forth as an objective standard.

In addition, the proposed regulations acknowledge that a qualifying activity in which the partnership engages could require extensive offsite services. Therefore, these proposed regulations provide

that the services may be conducted offsite if the services are performed on an ongoing or frequent basis and offered exclusively for those engaged in one or more section 7704(d)(1)(E) activities. For example, monitoring services will satisfy the significant services requirement if the monitoring is done on an ongoing or frequent basis only to support persons engaged in one or more section 7704(d)(1)(E) activities.

The proposed regulations also identify certain activities that do not qualify as significant services because they involve the manufacture and sale or temporary provision of a good. Thus, the design, construction, manufacturing, repair, maintenance, lease, rent, or temporary provision of assets is not taken into account when determining whether a partnership has provided significant services.

Proposed Effective/Applicability Date and Transition Rules

Except for rules concerning the Transition Period, these regulations are proposed to apply to income earned by a partnership in a taxable year beginning on or after the date these regulations are published as final regulations in the Federal Register. These regulations also provide for a Transition Period, which ends on the last day of the partnership's taxable year that includes the date that is ten years after the date that these regulations are published as final regulations in the **Federal Register**.

The proposed regulations provide that a partnership may treat income from an activity as qualifying income during the Transition Period if the partnership received a private letter ruling from the IRS holding that income from the activity is qualifying income. In addition, a partnership may treat income from an activity as qualifying income during the Transition Period if, prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as giving rise to qualifying income under section 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of these proposed regulations. In determining whether an interpretation was reasonable, the legislative history and interpretations applied by the IRS prior to the issuance of these proposed regulations

are taken into account. An interpretation was not reasonable merely because a partnership had a reasonable basis for that position. With respect to an activity undertaken prior to May 6, 2015, no inference is intended that an activity that is not described in these proposed regulations as a qualifying activity did or did not produce qualifying income under the statute and legislative history.

A partnership that is publicly traded and engages in an activity after May 6, 2015, but before the date these regulations are published as final regulations in the **Federal Register** may treat income from that activity as qualifying income during the Transition Period if the income from that activity is qualifying income under these 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, as supplemented by Executive Order 13563. 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 proposed regulations. Because these proposed 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, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its 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 comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled,

notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Caroline E. Hay, Office of the Associate Chief Counsel (Pass-throughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.7704-4 is added to read as follows:

§ 1.7704-4 Qualifying income – mineral and natural resources.

(a) *In general.* For purposes of section 7704(d)(1)(E), qualifying income includes only income and gains from qualifying activities with respect to minerals or natural resources as defined in paragraph (b) of this section. For purposes of section 7704(d)(1)(E), qualifying activities include section 7704(d)(1)(E) activities (as described in paragraph (c) of this section) and intrinsic activities (as described in paragraph (d) of this section).

(b) *Mineral or natural resource.* The term mineral or natural resource (including fertilizer, geothermal energy, and timber) means any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or other similar inexhaustible sources). For purposes of this section, the term mineral or natural resource does not include industrial source carbon dioxide, fuels described in section 6426(b) through (e), any alcohol fuel defined in

section 6426(b)(4)(A), or any biodiesel fuel as defined in section 40A(d)(1).

(c) *Section 7704(d)(1)(E) activities*—

(1) *Definition.* Section 7704(d)(1)(E) activities include the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource as limited to those activities described in this paragraph (c) or as provided by the Commissioner by notice or in other forms of published guidance. No other activities qualify as section 7704(d)(1)(E) activities.

(2) *Exploration.* An activity constitutes exploration if it is performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit by:

(i) Drilling an exploratory or stratigraphic type test well;

(ii) Conducting drill stem and production flow tests to verify commerciality of the deposit;

(iii) Conducting geological or geophysical surveys;

(iv) Interpreting data obtained from geological or geophysical surveys; or

(v) For minerals, testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146), (see § 601.601(d)(2)(ii)(b) of this chapter) if conducted prior to development activities with respect to the minerals.

(3) *Development.* An activity constitutes development if it is performed to make accessible minerals or natural resources by:

(i) Drilling wells to access deposits of mineral or natural resources;

(ii) Constructing and installing drilling, production, or dual purpose platforms in marine locations, or any similar supporting structures necessary for extraordinary non-marine terrain (such as swamps or tundra);

(iii) Completing wells, including by installing lease and well equipment, such as pumps, flow lines, separators, and storage tanks, so that wells are capable of producing oil and gas, and the production can be removed from the premises;

(iv) Performing a development technique such as, for minerals, stripping, benching and terracing, dredging by dra-

gline, stoping, and caving or room-and-pillar excavation, and for oil and natural gas, fracturing; or

(vi) Constructing and installing gathering systems and custody transfer stations.

(4) *Mining or production.* An activity constitutes mining or production if it is performed to extract minerals or other natural resources from the ground by:

(i) Operating equipment to extract natural resources from mines and wells; or

(ii) Operating equipment to convert raw mined products or raw well effluent to substances that can be readily transported or stored (for example, passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heat-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water).

(5) *Processing or refining*—(i) *In general.* Except as otherwise provided in paragraph (c)(5) of this section, an activity is processing or refining if it is done to purify, separate, or eliminate impurities. For an activity to be treated as processing or refining for purposes of this section, the partnership's position that an activity is processing or refining for purposes of this section must be consistent with the partnership's designation of an appropriate Modified Accelerated Cost Recovery System (MACRS) class life for assets used in the activity in accordance with Rev. Proc. 87-56, 1987-2 CB 674 (see § 601.601(d)(2)(ii)(b) of this chapter). For example, for an activity to be processing or refining of crude oil under paragraph (c)(5)(iii) of this section, the assets used in that process must also have a MACRS class life of 13.3, Petroleum Refining. Unless otherwise provided in this paragraph (c)(5), an activity will not qualify as processing or refining if the activity causes a substantial physical or chemical change in a mineral or natural resource, or transforms the extracted mineral or natural resource into new or different mineral products or into manufactured products.

(ii) *Natural Gas.* An activity constitutes processing of natural gas if it is performed to:

(A) Purify natural gas, including by removal of oil or condensate, water, or non-hydrocarbon gases (including carbon

dioxide, hydrogen sulfide, nitrogen, and helium);

(B) Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and gas condensate); or

(C) Convert methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.

(iii) *Petroleum*—(A) *Qualifying activities.* An activity constitutes processing or refining of petroleum if the end products of these processes are not plastics or similar petroleum derivatives and the activity is performed to:

(1) Physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes and similar products;

(2) Chemically convert the physically separated components if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline); or

(3) Physically separate products created through activities described in paragraph (c)(5)(iii)(A)(1) or (2) of this section.

(B) *Non-qualifying activities.* For purposes of this section, the following products are not obtained through processing of petroleum:

(1) Heat, steam, or electricity produced by the refining processes;

(2) Products that are obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts are sold; and

(3) Any product that results from further chemical change of the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil (for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as to anode-grade coke) does not qualify because it is further chemically changed).

(iv) *Ores and minerals.* An activity constitutes processing or refining of ores and minerals if it meets the definition of mining processes under § 1.613-4(f)(1)(ii) or refining under § 1.613-4(g)(6)(iii). Generally, refining of ores and minerals is any activity that eliminates impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as for example the refining of blister copper.

(v) *Timber.* An activity constitutes processing of timber if it is performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances. Processing of timber does not include activities that add chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp. Products that result from timber processing include wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark, and rough poles. Products that are not the result of timber processing include pulp, paper, paper products, treated lumber, oriented strand board/plywood, and treated poles.

(vi) *Fertilizer.* [Reserved]

(6) *Transportation.* Transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section, including by pipeline, barge, rail, or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers. Retail customers do not include a person who acquires oil or gas for refining or processing, or a utility. The following activities qualify as transportation—

- (i) Providing storage services;
- (ii) Terminalling;
- (iii) Operating gathering systems and custody transfer stations;
- (iv) Operating pipelines, barges, rail, or trucks; and
- (v) Construction of a pipeline only to the extent that a pipe is run to connect a producer or refiner to a preexisting interstate or intrastate line owned by the publicly traded partnership (interconnect agreements).

(7) *Marketing.* An activity constitutes marketing if it is performed to facilitate sale of minerals or natural resources and

products produced under paragraph (c)(4) or (5) of this section, including blending additives into fuels. Marketing does not include activities and assets involved primarily in retail sales (sales made in small quantities directly to end users), which includes, but is not limited to, operation of gasoline service stations, home heating oil delivery services, and local gas delivery services.

(d) *Intrinsic activities*—(1) *General requirements.* An activity is an intrinsic activity only if the activity is specialized to support a section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. Whether an activity is an intrinsic activity is determined on an activity-by-activity basis.

(2) *Specialization.* An activity is a specialized activity if:

(i) The partnership provides personnel to perform or support a section 7704(d)(1)(E) activity and those personnel have received training unique to the mineral or natural resource industry that is of limited utility other than to perform or support a section 7704(d)(1)(E) activity; and

(ii) To the extent that the activity includes the sale, provision, or use of property, either:

(A) The property is primarily tangible property that is dedicated to, and has limited utility outside of, section 7704(d)(1)(E) activities and is not easily converted (based on all the facts and circumstances, including the cost to convert the property) to another use other than supporting or performing the section 7704(d)(1)(E) activities; or

(B) The property is used as an injectant to perform a section 7704(d)(1)(E) activity that is also commonly used outside of section 7704(d)(1)(E) activities (such as water, lubricants, and sand) and, as part of the activity, the partnership also collects and cleans, recycles, or otherwise disposes of the injectant after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities.

(3) *Essential*—(i) An activity is essential to the section 7704(d)(1)(E) activity if it is required to—

(A) Physically complete a section 7704(d)(1)(E) activity (including in a cost

effective manner, such as by making the activity economically viable), or

(B) Comply with federal, state, or local law regulating the section 7704(d)(1)(E) activity.

(ii) Legal, financial, consulting, accounting, insurance, and other similar services do not qualify as essential to a section 7704(d)(1)(E) activity.

(4) *Significant services*—(i) An activity requires significant services to support the section 7704(d)(1)(E) activity if it must be conducted on an ongoing or frequent basis by the partnership's personnel at the site or sites of the section 7704(d)(1)(E) activities. Alternatively, those services may be conducted offsite if the services are performed on an ongoing or frequent basis and are offered exclusively to those engaged in one or more section 7704(d)(1)(E) activities. Whether services are conducted on an ongoing or frequent basis is determined based on all the facts and circumstances, including recognized best practices in the relevant industry.

(ii) Partnership personnel perform significant services only if those services are necessary for the partnership to perform an activity that is essential to the section 7704(d)(1)(E) activity, or to support the section 7704(d)(1)(E) activity.

(iii) An activity does not constitute significant services with respect to a section 7704(d)(1)(E) activity if the activity principally involves the design, construction, manufacturing, repair, maintenance, lease, rent, or temporary provision of property.

(e) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Petrochemical products sourced from an oil and gas well. (i) Z, a publicly traded partnership, chemically converts a mixture of ethane and propane (obtained from physical separation of natural gas) into ethylene, propylene, and other gases through use of a steam cracker.

(ii) Z's activities chemically convert physically separated components of natural gas. The chemical conversion of physically separated components of natural gas (ethane and propane) is not an activity that gives rise to qualifying income under paragraph (c)(5)(ii) of this section. Therefore, the income Z receives from the sale of ethylene and propylene is not qualifying income for purposes of section 7704(d)(1)(E).

Example 2. Petroleum streams chemically converted into refinery grade olefins byproducts. (i) Y, a publicly traded partnership, owns a petroleum refinery. Y classifies Y's assets used in the activity described in this paragraph under MACRS class 13.3

(Petroleum Refining). The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic cracking unit to chemically convert the heavy gas oil into a liquid stream suitable for gasoline blending and a gas stream containing ethane, ethylene, and other gases. The refinery also further physically separates the gas stream without additional chemical change, resulting in refinery grade ethylene. Y sells the ethylene to a third party.

(ii) Y's activities are performed to physically separate crude oil into its component parts and to chemically convert the separated heavy gas oil into a liquid stream for recombining with other physically separated components of crude oil. Y has classified its assets used in that activity under an appropriate MACRS code pursuant to paragraph (c)(5)(i) of this section. Income Y receives from the liquid stream is qualifying income pursuant to paragraph (c)(5)(iii)(A)(2) of this section. Y's further physical separation of the gas stream produces ethane, ethylene, and other gases. Pursuant to paragraph (c)(5)(iii)(A)(3), income Y receives from the physically separated gases is qualifying income because the heavy gas oil was chemically converted as part of a processing activity pursuant to paragraph (c)(5)(iii)(A)(2) of this section.

Example 3. Processing methane gas into synthetic fuels through chemical change. (i) Y, a publicly traded partnership, chemically converts methane into methanol and synthesis gas, and further chemically converts those products into gasoline and diesel fuel. Y receives income from sales of gasoline and diesel created during the conversion processes, as well as from sales of methanol.

(ii) With respect to the production of gasoline or diesel, Y is engaged in the processing of natural gas as provided in paragraph (c)(5)(ii)(C) of this section. The production and sale of methanol, an intermediate product in the conversion process, is not a section 7704(d)(1)(E) activity because methanol is not a liquid fuel otherwise produced from the processing of crude oil.

Example 4. Delivery of refined products. (i) X, a publicly traded partnership, sells diesel and lubricating oils to a government entity at wholesale prices and delivers those goods in bulk.

(ii) X's sale of refined products to the government entity is a section 7704(d)(1)(E) activity because it is a bulk transportation and sale as described in paragraphs (c)(6) and (7) of this section and is not a retail sale.

Example 5. Delivery of water. (i) X, a publicly traded partnership, owns interstate and intrastate natural gas pipelines. X built a water delivery pipeline along the existing right of way for its natural gas pipeline to deliver water to A for use in A's fracturing activity. A uses the delivered water in fracturing to develop A's natural gas reserve in a cost-efficient manner. X earns income for transporting natural gas in the pipelines and for delivery of water.

(ii) X's income from transporting natural gas in its interstate and intrastate pipelines is qualifying income for purposes of section 7704(c) because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(6) of this section.

(iii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as

provided in paragraph (c) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section. An activity is an intrinsic activity if the activity is specialized to narrowly support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. Under paragraph (d)(2)(ii)(B) of this section, the provision of water used in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership also collects and cleans, recycles, or otherwise disposes of the water after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities. Because X does not collect and clean, recycle, or otherwise dispose of the delivered water after use, X's water delivery activities are not specialized to narrowly support the section 7704(d)(1)(E) activity. Thus, X's water delivery is not an intrinsic activity. Accordingly, X's income from the delivery of water is not qualifying income for purposes of section 7704(c).

Example 6. Delivery of water and recovery and recycling of flowback. (i) Assume the same facts as in *Example 5*, except that X also collects and treats flowback at the drilling site in accordance with state regulations as part of its water delivery services and transports the treated flowback away from the site. In connection with these services, X provides personnel to perform these services on an ongoing or frequent basis that is consistent with best industry practices. X has provided these personnel with specialized training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas.

(ii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph (d) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section.

(iii) An activity is an intrinsic activity if the activity is specialized to narrowly support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. Under paragraph (d)(2)(ii)(B) of this section, the provision of water used in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership also collects and cleans, recycles, or otherwise disposes of the water after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities. X's provision of personnel is specialized because those personnel received training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of

natural gas. The provision of water is also specialized because water is an injectant used to perform a section 7704(d)(1)(E) activity, and X also collects and treats flowback in accordance with state regulations as part of its water delivery services. Therefore, X meets the specialized requirement. The delivery of water is essential to support A's development activity because the water is needed for use in fracturing to develop A's natural gas reserve in a cost-efficient manner. Finally, the water delivery and recovery and recycling activities require significant services to support the development activity because X's personnel provide services necessary for the partnership to perform the support activity at the development site on an ongoing or frequent basis that is consistent with best industry practices. Because X's delivery of water and X's collection, transport, and treatment of flowback is a specialized activity, is essential to the completion of a section 7704(d)(1)(E) activity, and requires significant services, the delivery of water and the transport and treatment of flowback is an intrinsic activity. X's income from the delivery of water and the collection, treatment, and transport of flowback is qualifying income for purposes of section 7704(c).

(f) *Proposed Effective/Applicability Date and Transition Rule*—(i) Except as provided in paragraph (f)(ii) of this section, this section is proposed to apply to income earned by a partnership in a taxable year beginning on or after the date these regulations are published as final regulations in the Federal Register. Paragraph (f)(ii) of this section applies during the Transition Period, which ends on the last day of the partnership's taxable year that includes the date that is ten years after the date that these regulations are published as final regulations in the **Federal Register**.

(ii) A partnership may treat income from an activity as qualifying income during the Transition Period if:

(A) The partnership received a private letter ruling from the IRS holding that the income from that activity is qualifying income;

(B) Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as giving rise to qualifying income under section 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of these proposed regulations; or

(C) The partnership is publicly traded and engages in the activity after May 6, 2015 but before the date these regulations are published as final regulations in the **Federal Register**, and the income from

that activity is qualifying income under these proposed regulations.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on May 5, 2015, 8:45 a.m., and published in the issue of the Federal Register for May 6, 2015, 80 F.R. 25970)

Notice of Proposed Rulemaking

Notional Principal Contracts; Swaps with Nonperiodic Payments

REG-102656-15

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing final and temporary regulations that amend the treatment of nonperiodic payments made or received pursuant to certain notional principal contracts. These regulations provide that, subject to certain exceptions, a notional principal contract with a nonperiodic payment, regardless of whether it is significant, must be treated as two separate transactions consisting of one or more loans and an on-market, level payment swap. The regulations provide an exception from the definition of United States property. These regulations affect parties making and receiving payments under notional principal contracts, including United States shareholders of controlled foreign corporations and tax-exempt organizations. The text of the temporary regulations also serves as the text of these proposed regulations. This document withdraws the notice of proposed rulemaking (REG-107548-11; RIN 1545-BK10) published in the **Federal Register** on May 11, 2012 (77 FR 27669).

DATES: Comments and requests for a public hearing must be received by August 6, 2015.

ADDRESSES: Send submissions to CC: PA:LPD:PR (REG-102656-15), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-102656-15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-102656-15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under section 446, Alexa T. Dubert or Anna H. Kim at (202) 317-6895; concerning the proposed regulations under section 956, Kristine A. Crabtree at (202) 317-6934; concerning submissions of comments or to request a public hearing, Oluwafunmilayo Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On May 11, 2012, the Treasury Department and the IRS published temporary regulations under section 956 (TD 9589) in the **Federal Register** (77 FR 27612). On the same date, a notice of proposed rulemaking (REG-107548-11) by cross-reference to the temporary regulations was published in the **Federal Register** (77 FR 27669). This document withdraws those proposed regulations (REG-107548-11; RIN 1545-BK10) and provides new proposed regulations (REG-102656-15).

Final and temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend the Income Tax Regulations (26 CFR Part 1). The final and temporary regulations amend the regulations under section 446 of the Internal Revenue Code (Code) relating to the treatment of nonperiodic payments made or received pursuant to certain notional principal contracts for U.S. federal income tax purposes. The final and temporary regulations also amend the regulations under sec-

tion 956 of the Code regarding an exception from the definition of United States property. The text of the final and temporary regulations also serves as the text of these proposed regulations. The preamble to the final and temporary regulations explains those regulations and these 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, as supplemented by Executive Order 13653. 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 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, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written 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 authors of these regulations are Alexa T. Dubert and Anna H. Kim of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the

Treasury Department and the IRS participated in their development.

* * * * *

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-107548-11 and RIN 1545-BK10) that was published in the **Federal Register** on May 11, 2012 (77 FR 27669) is withdrawn.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.446-3 is amended by:

1. Revising paragraph (g)(4).
2. Revising paragraph (g)(6), *Examples 2, 3 and 4*.
3. Revising paragraph (j)(2).

The revisions read as follows:

§ 1.446-3 *Notional principal contracts.*

* * * * *

(g) * * *

(4) [The text of the proposed amendment to § 1.446-3(g)(4) is the same as the text of § 1.446-3T(g)(4) published elsewhere in this issue of the **Federal Register**].

* * * * *

(6) * * *

Example 2. [The text of proposed amendment to § 1.446-3(g)(6) *Example 2* is the same as the text of § 1.446-3T(g)(6) *Example 2* published elsewhere in this issue of the **Federal Register**].

Example 3. [The text of proposed amendment to § 1.446-3(g)(6) *Example 3* is the same as the text of § 1.446-3T(g)(6) *Example 3* published elsewhere in this issue of the **Federal Register**].

Example 4. [The text of proposed amendment to § 1.446-3(g)(6) *Example 4* is the same as the text of § 1.446-3T(g)(6) *Example 4* published elsewhere in this issue of the **Federal Register**].

* * * * *

(j) * * *

(2) [The text of the proposed amendment to § 1.446-3(j)(2) is the same as the text of § 1.446-3T(j)(2) published else-

where in this issue of the **Federal Register**].

Par. 3. Section 1.956-2 is amended by revising paragraphs (b)(1)(xi) and (f) to read as follows:

§ 1.956-2 *Definition of United States property.*

* * * * *

(b)(1)(xi) [The text of this proposed amendment is the same as the text of § 1.956-2T(b)(1)(xi) published elsewhere in this issue of the **Federal Register**].

* * * * *

(f) [The text of this proposed amendment is the same as the text of § 1.956-2T(f) published elsewhere in this issue of the **Federal Register**].

John M. Dalrymple
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on May 7, 2015, 8:45 a.m., and published in the issue of the Federal Register for May 8, 2015, 89 F.R. 26500)

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 sub-

stance 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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¹A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2014–27 through 2014–52 is in Internal Revenue Bulletin 2014–52, dated December 28, 2014.

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¹A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2014–27 through 2014–52 is in Internal Revenue Bulletin 2014–52, dated December 28, 2014.

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INTERNAL REVENUE BULLETIN

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at *www.irs.gov/irb/*.

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If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page (*www.irs.gov*) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.