

# 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-122855-15, page 922.**

Proposed regulations incorporate the text of temporary regulations (TD 9788) concerning a partner's share of partnership liabilities for purposes of section 707 of the Code and the treatment of certain payment obligations under section 752. In addition, the proposed regulations address (1) when certain obligations to restore a deficit balance in a partner's capital account are disregarded under section 704 and (2) when partnership liabilities are treated as recourse liabilities under section 752.

### **REG-129128-14, page 931.**

The proposed regulations provide rules under section 901(m) for determining the amount of foreign taxes that are disqualified for foreign tax credit purposes with respect to certain covered asset acquisitions that result in a basis step-up for U.S. income tax purposes but not foreign tax purposes.

### **Rev. Rul. 2016-29, page 875.**

This revenue ruling relates to allocations of low-income housing credits to qualified low-income buildings. Specifically, the revenue ruling clarifies that section 42(m)(1)(A)(ii) neither requires nor encourages State housing credit agencies to reject the proposed development of a low-income housing project that does not obtain the approval of the locality where the project is proposed to be developed.

### **Rev. Rul. 2016-30, page 876.**

Section 1274A – inflation adjusted numbers for 2017. This ruling provides the dollar amounts, increased by the 2017 inflation adjustments, for section 1274A of the Code. Revenue Ruling 2015-24 supplemented and superseded.

### **Rev. Proc. 2016-56, page 920.**

This revenue procedure provides an updated list of countries with which the reporting requirement of §§1.6049-8(a) and 1.6049-4(b)(5) of the Income Tax Regs. applies (Section 3), as

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well as a list of countries with which the Treasury Department and the IRS have determined that it is appropriate to have an automatic exchange relationship with respect to that interest income information under §§1.6049-8(a) and 1.6049-4(b)(5) (Section 4). This rev proc adds one country (Saint Lucia) to the list set forth in Section 3 and three countries (Israel, the Republic of Korea, and Saint Lucia) to the list set forth in Section 4.

### **Notice 2016-73, page 908.**

The notice provides rules relating to the treatment of property used to acquire parent stock or securities in certain triangular reorganizations involving one or more foreign corporations. In addition, the notice announces that the Treasury and IRS will revise the regulations under section 367 in the manner described in the notice, and states our view that the IRS intends to challenge the purported tax consequences of these transactions under current law.

### **Notice 2016-77, page 914.**

This notice relates to a preference needed in a qualified allocation plan (QAP) for certain areas. Specifically, the notice reminds taxpayers that a project located in a qualified census tract (as defined in section 42(d)(5)) is not described in section 42(m)(1)(B)(ii)(III) (i.e., was not given a preference required in a QAP) unless the development of the project contributes to a concerted community revitalization plan.

### **Notice 2016-79, page 918.**

This notice provides the optional 2017 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate (FAVR) plan.

**(Continued on the next page)**

**T.D. 9787, page 878.**

Final regulations under section 707 of the Code relate to disguised sales of property to or by a partnership. The regulations address certain deficiencies and technical ambiguities in the existing section 707 regulations, including issues in determining a partner's share of liabilities under section 1.752-3 for disguised sale purposes.

**T.D. 9788, page 889.**

Final and temporary regulations provide guidance concerning a partner's share of partnership liabilities for purposes of section 707 of the Code and the treatment of certain payment obligations under section 752.

**T.D. 9800, page 899.**

The temporary regulations provide rules under section 901(m) for determining the amount of foreign taxes that are disqualified for foreign tax credit purposes with respect to certain covered asset acquisitions that result in a basis step up for U.S. income tax purposes but not foreign tax purposes.

## **EMPLOYEE PLANS**

**Notice 2016-78, page 914.**

This notice sets forth updates on the corporate bond monthly yield curve, the corresponding spot segment rates for December 2016 used under § 417(e)(3)(D), the 24-month average segment rates applicable for December 2016, and the 30-year Treasury rates. These rates reflect the application of § 430(h)(2)(C)(iv), which was added by the Moving Ahead for Progress in the 21st Century Act, Public Law 112-141 (MAP-21) and amended by section 2003 of the Highway and Transportation Funding Act of 2014 (HATFA).

**Notice 2016-80, page 918.**

This notice contains the 2016 Required Amendments List for individually-designed qualified retirement plans. The list identifies certain changes in qualification requirements that became effective in 2016 that may require a retirement plan to be amended in order to remain qualified, and establishes the date by which any necessary amendment must be made.

# 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.

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

## Section 42.—Low-Income Housing Credit

26 CFR 1.42–14: Allocation rules for post-2000 State housing credit ceiling amount.

### Rev. Rul. 2016–29

#### ISSUE

When state housing credit agencies allocate housing credit dollar amounts, does § 42(m)(1)(A)(ii) of the Internal Revenue Code (Code) require or encourage these agencies to reject any proposal that does not obtain the approval of the locality where the project developer proposes to place the project?<sup>1</sup>

#### FACTS

*Agency*, a housing credit agency in State X, is responsible for allocating housing credit dollar amounts to applicants that seek to develop affordable housing projects that will be eligible to earn low-income housing tax credits (LIHTCs). To guide *Agency* in making these allocations, *Agency* adopted, and the relevant governmental unit approved, a qualified allocation plan (QAP).

This QAP contains provisions that strongly favor applications from affordable housing projects that demonstrate affirmative local support. For example, under the point system that *Agency* uses in judging among applicant projects, points are granted to projects that—

- Manifest quantifiable community participation with respect to the project, especially as evidenced by written statements from neighborhood organizations in the area of the proposed project.
- Receive a commitment of development funding by the local political subdivision.

- Receive community support for the application, as evidenced by a written statement from the state legislator elected from the district in which the project is proposed to be developed.

*Agency* believes that § 42(m)(1)(A)(ii) requires that allocations be made only to proposals that receive the approval of the locality where the proposed project is to be located. Accordingly, *Agency* will reject an application if evidence of affirmative local support is lacking, and *Agency* uses factors such as the ones in its QAP to determine whether or not that support exists. Requiring local approval empowers jurisdictions to exercise what some call a “local veto.”

In State X, local approval is much more likely to be secured for proposed LIHTC developments in areas with greater proportions of minority residents and fewer economic opportunities than in higher-opportunity, non-minority communities. *Agency’s* practice of requiring local approval has created a pattern of allocating housing credit dollar amounts to projects in the predominantly lower-income or minority areas, with the result of perpetuating residential racial and economic segregation in State X.

#### LAW

If a building is constructed and operated consistent with the requirements of § 42, the building’s owners generally receive a 10-year stream of LIHTCs.

Under § 42(h), however, the LIHTCs determined in any year with respect to a building may not exceed the housing credit dollar amount that a State housing credit agency has allocated to the building.

Section 42(m) requires these allocations to be made pursuant to a QAP. Each QAP must contain certain preferences,

and selection criteria, specified in the Code, but other factors may be added.

Section 42(m)(1)(A)(ii) prevents a housing credit dollar amount from being allocated to a building unless the allocating “agency notifies the chief executive officer (or the equivalent) of the local jurisdiction within which the building is located of such project and provides such individual a reasonable opportunity to comment on the project.”

#### ANALYSIS

Although *Agency* believes that the local veto provisions in its QAP respond to the requirement in § 42(m)(1)(A)(ii), *Agency* misinterprets this provision. *Agency’s* interpretation is inconsistent with (1) the language of § 42(m)(1)(A)(ii) and (2) general Federal fair-housing policy.

##### 1. *The Language of Section 42(m)(1)(A)(ii)*

The Code requires that each local jurisdiction have a “reasonable opportunity” to comment on any proposal to allocate a housing credit dollar amount to a project within that jurisdiction. This requirement is not the same as requiring the jurisdiction’s approval. The clear meaning of “reasonable opportunity to comment” is that the jurisdiction has a chance to weigh in, or even object, but not that every objection will be honored.

Thus, § 42(m)(1)(A)(ii) ensures only the opportunity for local input to the allocation decision. It does not authorize an allocating agency to abandon the responsibility to exercise its own judgment. In particular, it does not require or encourage allocating agencies to bestow veto power over LIHTC projects either on local communities or on local public officials.

<sup>1</sup>Section 147(f) requires public approval for all issuances of proposed qualified private activity bonds, including bonds used to finance qualified residential rental projects. These bond issuances must be approved both (a) by the governmental unit which is to issue the bonds or on behalf of which they are to be issued (issuer approval) and (b) by a governmental unit the geographic jurisdiction of which includes the site of the facility to be financed (host approval). Although the host-approval component of public approval means approval by a governmental unit whose jurisdiction includes the site of the financed facility, “public approval” (including “host approval”) does not include “local approval.” To illustrate, bonds issued by (or on behalf of) a State may be approved by the State alone in its capacities as issuer and as a host governmental unit whose jurisdiction includes the site of the financed facility. So there is no requirement for local approval by the county or municipality in which the financed facility is to be located. See § 5f.103–2(c) of the Temporary Income Tax Regulations Under the Tax Equity and Fiscal Responsibility Act of 1982. Thus, § 42(m)(1)(A)(ii) neither requires nor encourages local approval for these bond-financed projects, although § 147 does require public approval for issuing the bonds.

## 2. General Federal Fair-Housing Policy

Agency's practice of requiring local approval has created a pattern of allocating housing credit dollar amounts that has perpetuated residential racial segregation in State X. Agency's practice, therefore, has a discriminatory effect based on race, which is a protected characteristic under 42 USC 3604. Thus, the practice is inconsistent with at least the policy<sup>2</sup> of the Fair Housing Act of 1968 (the Act), 42 USC 3601–3619.

Nevertheless, Agency interprets § 42 (m)(1)(A)(ii) as forcing Agency to require local approval, despite the discriminatory effect of that practice in State X. This interpretation assumes that, in creating LIHTCs, Congress silently reversed well-established, fundamental Federal fair-housing policy. Eighteen years before the 1986 enactment of § 42, the Act had firmly established this policy. See 42 USC 3601 (“**Declaration of policy.** It is the policy of the United States to provide, within constitutional limitations, for fair housing throughout the United States.”). Without legislative commentary or other persuasive evidence, one cannot conclude that Congress intended to reverse this well-established policy.

In the summer of 2015, the United States Department of Housing and Urban Development (HUD) issued new final regulations regarding obligations under the Act to Affirmatively Further Fair Housing (AFFH). See 80 Fed. Reg. 42272 (2015) (issuing HUD's AFFH final rule, which is codified at various locations in 24 CFR Parts 5, 91, 92, 570, 574, 576, and 903). Discussing the many decades during which AFFH had been firmly established Federal policy, HUD states in the preamble, “*From its inception [in 1968], the [Act] . . . has not only prohibited discrimination in housing related activities and transactions but has also provided, through the duty to affirmatively further fair housing . . . , for meaningful actions to be taken to overcome the legacy of segregation, unequal treatment, and historic lack of access to opportunity in housing.*” *Id.* at 42272 (emphasis added).

AFFH was firmly established Federal housing policy when § 42 was enacted,

and there is no suggestion that Congress intended § 42 to diverge from that policy. Section 42(m)(1)(A)(ii), therefore, does not require or even encourage conduct inconsistent with that policy.

### HOLDING

When state housing credit agencies allocate housing credit dollar amounts, § 42(m)(1)(A)(ii) does not require or encourage these agencies to reject all proposals that do not obtain the approval of the locality where the project developer proposes to place the project. That is, it neither requires nor encourages housing credit agencies to honor local vetoes.

### DRAFTING INFORMATION

The principal author of this revenue ruling is James W. Rider of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, please contact Mr. Rider at (202) 317-4137 (not a toll-free number).

## Rev. Rul. 2016–30

This revenue ruling provides the dollar amounts, increased by the 2017 inflation adjustment, for § 1274A of the Internal Revenue Code.

### BACKGROUND

In general, §§ 483 and 1274 determine the principal amount of a debt instrument given in consideration for the sale or exchange of nonpublicly traded property. In addition, any interest on a debt instrument subject to § 1274 is taken into account under the original issue discount provisions of the Code. Section 1274A, however, modifies the rules under §§ 483 and 1274 for certain types of debt instruments.

In the case of a “qualified debt instrument,” the discount rate used for purposes of §§ 483 and 1274 may not exceed nine percent, compounded semiannually. Section 1274A(b) defines a qualified debt instrument as any debt instrument given in consideration for the sale or exchange of property (other than new § 38 property within the meaning of § 48(b), as in effect

on the day before the date of enactment of the Revenue Reconciliation Act of 1990) if the stated principal amount of the instrument does not exceed the amount specified in § 1274A(b). For debt instruments arising out of sales or exchanges before January 1, 1990, this amount is \$2,800,000.

In the case of a “cash method debt instrument,” as defined in § 1274A(c), the borrower and lender may elect to use the cash receipts and disbursements method of accounting. In particular, for any cash method debt instrument, § 1274 does not apply, and interest on the instrument is accounted for by both the borrower and the lender under the cash receipts and disbursements method of accounting. A cash method debt instrument is a qualified debt instrument that meets the following additional requirements: (A) in the case of a debt instrument arising out of a sale or exchange before January 1, 1990, the stated principal amount does not exceed \$2,000,000; (B) the lender does not use an accrual method of accounting and is not a dealer with respect to the property sold or exchanged; (C) § 1274 would have applied to the debt instrument but for an election under § 1274A(c); and (D) an election under § 1274A(c) is jointly made with respect to the debt instrument by the borrower and the lender. Section 1.1274A–1(c)(1) of the Income Tax Regulations provides rules concerning the time for, and manner of, making this election.

Section 1274A(d)(2) provides that, for any debt instrument arising out of a sale or exchange during any calendar year after 1989, the dollar amounts stated in § 1274A(b) and § 1274A(c)(2)(A) are increased by the inflation adjustment for the calendar year. Any increase due to the inflation adjustment is rounded to the nearest multiple of \$100 (or, if the increase is a multiple of \$50 and not of \$100, the increase is increased to the nearest multiple of \$100). The inflation adjustment for any calendar year is the percentage (if any) by which the CPI for the preceding calendar year exceeds the CPI for calendar year 1988. Section 1274A(d)(2)(B) defines the CPI for any calendar year as the average of the Con-

<sup>2</sup>The practice may also violate specific nondiscrimination provisions of the Act. See *Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmty. Project, Inc.*, 135 S. Ct. 2507 (2015).

sumer Price Index as of the close of the 12-month period ending on September 30 of that calendar year.

**INFLATION-ADJUSTED AMOUNTS UNDER § 1274A**

1989, the inflation-adjusted amounts under § 1274A are shown in Table 1.

For debt instruments arising out of sales or exchanges after December 31,

Rev. Rul. 2016–30 Table 1  
Inflation-Adjusted Amounts Under Section 1274A

Calendar Year of Sale or Exchange	1274A(b) Amount (qualified debt instrument)	1274A(c)(2)(A) Amount (cash method debt instrument)
1990	\$2,933,200	\$2,095,100
1991	\$3,079,600	\$2,199,700
1992	\$3,234,900	\$2,310,600
1993	\$3,332,400	\$2,380,300
1994	\$3,433,500	\$2,452,500
1995	\$3,523,600	\$2,516,900
1996	\$3,622,500	\$2,587,500
1997	\$3,723,800	\$2,659,900
1998	\$3,823,100	\$2,730,800
1999	\$3,885,500	\$2,775,400
2000	\$3,960,100	\$2,828,700
2001	\$4,085,900	\$2,918,500
2002	\$4,217,500	\$3,012,500
2003	\$4,280,800	\$3,057,700
2004	\$4,381,300	\$3,129,500
2005	\$4,483,000	\$3,202,100
2006	\$4,630,300	\$3,307,400
2007	\$4,800,800	\$3,429,100
2008	\$4,913,400	\$3,509,600
2009	\$5,131,700	\$3,665,500
2010	\$5,115,100	\$3,653,600
2011	\$5,201,300	\$3,715,200
2012	\$5,339,300	\$3,813,800
2013	\$5,468,200	\$3,905,900
2014	\$5,557,200	\$3,969,500
2015	\$5,647,300	\$4,033,800
2016	\$5,664,800	\$4,046,300
2017	\$5,717,400	\$4,083,800

*Note:* These inflation adjustments were computed using the All-Urban, Consumer Price Index, 1982–1984 base, published by the Bureau of Labor Statistics.

**EFFECT ON OTHER DOCUMENTS**

Rev. Rul. 2015–24, 2015–48 I.R.B. 687, is supplemented and superseded.

**DRAFTING INFORMATION**

The author of this revenue ruling is Bernard Audet of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Bernard

Audet at (202) 317-7053 (not a toll-free number).

## Section 483.—Interest on Certain Deferred Payments.

This ruling provides the dollar amounts, increased by the 2017 inflation adjustment, for section 1274A of the Code. Rev. Rul. 2015–24 supplemented and superseded. See Rev. Rul. 2016–30, page 876.

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

This ruling provides the dollar amounts, increased by the 2017 inflation adjustment, for section 1274A of the Code. Rev. Rul. 2015–24 supplemented and superseded. See Rev. Rul. 2016–30, page 876.

26 CFR 1.704–2; 1.707–3 through 1.707–6, and 1.707–9; and 1.752–3: Section 707 regarding disguised sales, generally.

### T.D. 9787

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

### Section 707 Regarding Disguised Sales, Generally

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under sections 707 and 752 of the Internal Revenue Code (Code). The final regulations under section 707 provide guidance relating to disguised sales of property to or by a partnership and the final regulations under section 752 provide guidance relating to allocations of excess nonrecourse liabilities of a partnership to partners for disguised sale purposes. The final regulations affect partnerships and their partners.

DATES: *Effective date:* These regulations are effective on October 5, 2016.

*Comment date:* Comments will be accepted until January 3, 2017.

*Applicability dates:* For dates of applicability, see §§ 1.707–9(a)(1) and 1.752–3(d).

ADDRESSES: Send submissions to: CC: PA:LPD:PR (REG–122855–15), room 5203, 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–122855–15), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal site at <http://www.regulations.gov> (indicate IRS and REG–122855–15).

FOR FURTHER INFORMATION CONTACT: Deane M. Burke or Caroline E. Hay at (202) 317-5279 (not a toll-free number).

SUPPLEMENTARY INFORMATION: In addition to these final regulations, the Treasury Department and the IRS are publishing temporary regulations concerning a partner’s share of partnership liabilities for purposes of section 707 (the 707 Temporary Regulations) and the treatment of certain payment obligations under section 752 (the 752 Temporary Regulations) in the Rules and Regulations section in this issue of the **Bulletin**, and, in the Proposed Rules section in this issue of the **Bulletin**, proposed regulations (REG–122855–15) that incorporate the text of the temporary regulations, withdraw a portion of a notice of proposed rulemaking (REG–119305–11) to the extent not adopted by the final regulations, and contain new proposed regulations (the 752 Proposed Regulations) addressing (1) when certain obligations to restore a deficit balance in a partner’s capital account are disregarded under section 704 and (2) when a partnership’s liabilities are treated as recourse liabilities under section 752.

### Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and approved by the Office of Management

and Budget under control number 1545-0889.

The collection of information in these final regulations under section 707 is in § 1.707–5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property) and is reported on Form 8275, Disclosure Statement. This information is required by the IRS to ensure that section 707(a)(2)(B) of the Code and applicable regulations are properly applied to transfers between a partner and a partnership.

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

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

### Background

#### 1. Overview

This Treasury decision contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 707 and 752 of the Code related to a notice of proposed rulemaking published on January 30, 2014 in the **Federal Register** (REG–119305–11, 79 FR 4826) to amend regulations under sections 707 and 752 (the 2014 Proposed Regulations). A public hearing on the 2014 Proposed Regulations was not requested or held, but the Treasury Department and the IRS received written comments. After full consideration of the comments, the final regulations contained in this Treasury decision substantially adopt the 2014 Proposed Regulations under section 707 with revisions to certain proposed rules in response to comments. The revisions to the 2014 Proposed Regulations under section 707 adopted in these final regulations are discussed in the Summary of Comments and Explanation of Revisions section of this preamble. In addition, after considering comments on the 2014 Proposed Regulations under section 752, this Treasury decision adopts as final regulations provisions of the 2014 Proposed Regulations

that amend § 1.752-3, revised in response to the comments received. Finally, these final regulations adopt provisions of the 2014 Proposed Regulations revising § 1.704-2(d)(2)(ii) and (m) *Example 1*, to comport with the provisions in the 752 Proposed Regulations and the 752 Temporary Regulations relating to “bottom dollar payment obligations.”

However, based on a comment received on the 2014 Proposed Regulations requesting that guidance regarding a partner’s share of partnership liabilities apply solely for disguised sale purposes, the Treasury Department and the IRS have reconsidered the rules under § 1.707-5(a)(2) of the 2014 Proposed Regulations for determining a partner’s share of partnership liabilities for purposes of section 707. Accordingly, in a separate Treasury decision (TD 9788), the Treasury Department and the IRS are also publishing the 707 Temporary Regulations that require a partner to apply the same percentage used to determine the partner’s share of excess nonrecourse liabilities under § 1.752-3(a)(3) (with certain limitations) in determining the partner’s share of partnership liabilities for disguised sale purposes. That Treasury decision also contains the 752 Temporary Regulations providing guidance on the treatment of “bottom dollar payment obligations.” Cross-referencing proposed regulations providing additional opportunity for comment are contained in the related notice of proposed rulemaking (REG-122855-15) published in the Proposed Rules section in this issue of the **Bulletin**.

Finally, after considering comments on the 2014 Proposed Regulations under section 752, the Treasury Department and the IRS are withdrawing § 1.752-2 of the 2014 Proposed Regulations and are publishing the new 752 Proposed Regulations contained in the related notice of proposed rulemaking (REG-122855-15) published in the Proposed Rules section in this issue of the **Bulletin**.

## 2. Summary of Applicable Law

### A. Section 707

Section 707 provides rules concerning “disguised sales” of property to or by a partnership. Section 707(a)(2)(B) generally provides that, under regulations prescribed by the Secretary, related transfers

to and by a partnership that, when viewed together, are more properly characterized as a sale or exchange of property, will be treated either as a transaction between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. Generally under § 1.707-3, a transfer of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership (a disguised sale), if based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property and, for non-simultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership.

The existing regulations under section 707, however, provide several exceptions. One exception is in § 1.707-4(d) for reimbursements of capital expenditures. Section 1.707-4(d) excepts transfers of money or other consideration from a partnership to reimburse a partner for certain capital expenditures and costs incurred by the partner from being treated as part of a disguised sale of property under § 1.707-3 (exception for preformation capital expenditures). The exception for preformation capital expenditures generally applies only to the extent that the reimbursed capital expenditures do not exceed 20 percent of the fair market value of the property transferred by the partner to the partnership (the 20-percent limitation). The 20-percent limitation, however, does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner’s adjusted basis in the property at the time of the transfer (the 120-percent test).

Another exception is in § 1.707-5(b), which generally provides that if a partner transfers property to a partnership, the partnership incurs a liability and all or a portion of the proceeds of that liability are traceable to a transfer of money or other consideration to the partner, the transfer of money or other consideration is taken into account for purposes of § 1.707-3 only to the extent that the amount of money or the fair market value of other consideration exceeds the partner’s allocable share of

the partnership liability (the debt-financed distribution exception).

In addition to the exception for preformation capital expenditures and the debt-financed distribution exception, the disguised sale rules generally exclude certain types of liabilities from disguised sale treatment. Generally under § 1.707-5(a)(5), a partnership’s assumption of a qualified liability, or a partnership’s taking property subject to a qualified liability, in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. Section 1.707-5(a)(6) of the existing regulations defines four types of liabilities that are qualified liabilities. One type of qualified liability is a liability that is allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to the partnership. Another type is one incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all of the assets that are material to that trade or business are transferred to the partnership. The other two types of qualified liabilities are liabilities incurred more than two years before the transfer of property to the partnership and liabilities incurred within two years of the transfer of the property to the partnership, but not in anticipation of transfer to the partnership. In order to qualify as one of these types of liabilities, it is required that the liability encumber the transferred property.

### B. Determining a partner’s share of liability for disguised sale purposes

In determining a partner’s share of a partnership liability for disguised sale purposes, the existing regulations under section 707 prescribe separate rules for a partnership’s recourse liability and a partnership’s nonrecourse liability. Under § 1.707-5(a)(2)(i), a partner’s share of a partnership’s recourse liability equals the partner’s share of the liability under section 752 and the regulations thereunder. A partnership liability is a recourse liability under section 707 to the extent that the obligation is a recourse liability under § 1.752-1(a)(1). Under § 1.707-5(a)(2)(ii), a partner’s share of a partnership’s nonrecourse liability is determined by ap-

plying the same percentage used to determine the partner's share of the excess nonrecourse liabilities under § 1.752-3(a)(3). Generally, a partner's share of excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits taking into account all facts and circumstances relating to the economic arrangement of the partners. A partnership liability is a nonrecourse liability under section 707 to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2). Also for purposes of the rules under section 707, a partner's share of a liability assumed or taken subject to by a partnership is determined by taking into account certain subsequent reductions in the partner's share of the liability under an anticipated reduction rule.

### *C. Section 752 allocation of excess nonrecourse liabilities*

Section 1.752-3(a)(3) provides various methods to determine a partner's share of excess nonrecourse liabilities. Under one method, a partner's share of excess nonrecourse liabilities of the partnership is determined in accordance with the partner's share of partnership profits, which takes into account all facts and circumstances relating to the economic arrangement of the partners. For this purpose, the partnership agreement may specify the partners' interests in partnership profits so long as the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (the significant item method). Alternatively, excess nonrecourse liabilities may be allocated among partners in a manner that deductions attributable to those liabilities are reasonably expected to be allocated (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability, to the extent

that such built-in gain exceeds the gain described in § 1.752-3(a)(2) with respect to such property (additional method). This additional method does not apply in determining a partner's share of a liability for disguised sale purposes.

### *3. The 2014 Proposed Regulations*

As discussed in greater detail in the Summary of Comments and Explanation of Provisions section of this preamble, the 2014 Proposed Regulations, as they pertained to section 707, were intended to address certain deficiencies and ambiguities under existing regulations §§ 1.707-3, 1.707-4, and 1.707-5. The 2014 Proposed Regulations, among other things, provided rules that (1) clarified that in the case of multiple property contributions to a partnership, the exception for preformation capital expenditures applies on a property-by-property basis, (2) clarified the definition of capital expenditures for the purpose of the exception for preformation capital expenditures, (3) coordinated the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures, (4) added a new type of qualified liability, (5) prescribed an ordering rule for applying the debt-financed distribution exception where other exceptions also potentially applied, (6) specified that a reduction that is subject to the entrepreneurial risks of the partnership is not an anticipated reduction for purposes of the rule taking into account an anticipated reduction in a partner's share of a liability, (7) clarified, with respect to tiered partnerships, the application of the debt-financed distribution exception and the application of the rules for qualified liabilities, and (8) extended the principles of § 1.752-1(f) providing for netting of increases and decreases in a partner's share of liabilities resulting from a single transaction to the disguised sale rules.

### **Summary of Comments and Explanation of Revisions**

#### *1. Preformation Capital Expenditures*

As explained above, § 1.707-4(d) exempts transfers of money or other consideration from a partnership to reimburse a partner for certain capital expenditures

and costs incurred by the partner from being treated as part of a disguised sale of property under § 1.707-3, subject to the 20 percent limitation and the 120 percent test.

The 2014 Proposed Regulations under section 707 provided that the determination of whether the 20 percent limitation and the 120 percent test apply to reimbursements of capital expenditures is made, in the case of multiple property transfers, separately for each property that qualifies for the exception (property-by-property rule). Commenters generally supported the property-by-property rule but noted that in some circumstances the approach may be burdensome and recommended limited aggregation of certain property. After considering the comments, the Treasury Department and the IRS have determined that limited aggregation of property is warranted in certain cases to reduce the burden of separately accounting for each property under the property-by-property rule. Thus, the final regulations adopt the proposed rule but permit aggregation to the extent: (i) the total fair market value of the aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or \$1,000,000; (ii) the partner uses a reasonable aggregation method that is consistently applied; and (iii) the aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5. Additionally, the final regulations add an example to illustrate the application of the property-by-property rule when a partner transfers both tangible and intangible property to a partnership.

In addition to the property-by-property rule, the 2014 Proposed Regulations provided a rule coordinating the exception for preformation capital expenditures with a rule regarding one type of qualified liability (within the meaning of § 1.707-5(a)(6)) under § 1.707-5(a)(6)(i)(C). Under § 1.707-5(a)(6)(i)(C), a liability that is allocable under the rules of § 1.163-8T to capital expenditures with respect to the

property transferred to the partnership by the partner is a qualified liability (capital expenditure qualified liability). Generally under § 1.707-5(a)(5), a partnership's assumption of a qualified liability, or a partnership's taking property subject to a qualified liability, in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. To coordinate the exception for preformation capital expenditures and the capital expenditure qualified liability rule under § 1.707-5(a)(6)(i)(C), the 2014 Proposed Regulations provided that to the extent a partner funded a capital expenditure through a capital expenditure qualified liability and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures would not apply because there is no outlay by the partner to reimburse.

A commenter suggested that the final regulations broaden this proposed rule to include any qualified liability under § 1.707-5(a)(6) used to fund capital expenditures, not just a capital expenditure qualified liability under § 1.707-5(a)(6)(i)(C). The final regulations adopt the suggestion and provide that to the extent any qualified liability under § 1.707-5(a)(6) is used by a partner to fund capital expenditures and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures does not apply. Under the final regulations, capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under § 1.163-8T or are actually used to fund the capital expenditures, irrespective of the tracing requirements under § 1.163-8T. However, under an anti-abuse provision, if capital expenditures and a qualified liability are incurred under a plan a principal purpose of which is to avoid the requirements of this coordinating rule, the capital expenditures are deemed funded by the qualified liability.

Finally, it has come to the attention of the Treasury Department and the IRS that some partners have taken the position that the disclosure requirements of § 1.707-3(c)(2) are not applicable to situations in which the partners believe that one or

more of the exceptions for disguised sale treatment are applicable, including the exception for preformation capital expenditures. The Treasury Department and the IRS remind taxpayers that disclosure is required whenever money or other consideration is transferred by a partnership to a partner within two years of the transfer of property by the partner to the partnership, except in the limited situations described in § 1.707-3(c)(2)(iii).

Notwithstanding the final regulations, the Treasury Department and the IRS continue to study the appropriateness of the exception for preformation capital expenditures. Specifically, because the receipt of "boot" in the context of other nonrecognition transactions, for example, transfers of property to corporations in section 351 transactions, is generally taxable to the transferor, the Treasury Department and the IRS are considering whether the exception for preformation capital expenditures is appropriate and request comments on whether the regulations should continue to include the exception, including any policy justifications for keeping the exception, and on the effects that removing the exception may have. In addition, the Treasury Department and the IRS are concerned that partners and partnerships may be attempting to apply the exception in an unintended manner such that the exception may be subject to potential abuses in certain circumstances that could effectively refresh expenditures not incurred within the two-year period preceding a contribution to a partnership (for example, where an entity treats as a capital expenditure an issuance of its own interest in exchange for property contributed to it in a nonrecognition transaction). Also, the Treasury Department and the IRS are aware that a contribution to a partnership of an intangible such as goodwill, may, in certain circumstances, give rise to an unintended benefit under the exception. The Treasury Department and the IRS are studying the potential for abuse under the exception for preformation capital expenditures, including any unintended benefits with respect to intangibles, for which the final regulations reserve a section under the exception.

## 2. Partner's Share of Partnership Liabilities

As is discussed in the preamble to the 707 Temporary Regulations, after considering the comments on the 2014 Proposed Regulations under both sections 707 and 752, the Treasury Department and the IRS have determined that, for disguised sale purposes only, it is appropriate for partners to determine their share of any liability, whether recourse or nonrecourse, in the manner in which excess nonrecourse liabilities are allocated under § 1.752-3(a)(3). Accordingly, under the 707 Temporary Regulations a partner's share of any partnership liability for disguised sale purposes is determined using the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under § 1.752-3(a)(3) based on the partner's share of partnership profits. Thus, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for disguised sale purposes under section 707. These final regulations, however, provide limitations on the available allocation methods under § 1.752-3(a)(3), applicable solely for disguised sale purposes under section 707, for determining a partner's share of excess nonrecourse liabilities.

For purposes of allocating excess nonrecourse liabilities under § 1.752-3(a)(3), proposed § 1.752-3(a)(3) removed the significant item method and the alternative method, but provided a new approach based on a partner's liquidation value percentage. Under the 2014 Proposed Regulations, a partner's liquidation value percentage was a ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership to the liquidation value of all of the partners' interests in the partnership. The liquidation value of a partner's interest in a partnership was defined as the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or the occurrence of an event described in § 1.704-1(b)(2)(iv)(f)(5), as the case may be, the partnership sold all of its assets for cash equal to the fair market value of such property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described

in § 1.752-7), paid an unrelated third party to assume all of its § 1.752-7 liabilities in a fully taxable transaction, and then liquidated.

Commenters expressed concerns with the scope of changes to § 1.752-3(a)(3) in the 2014 Proposed Regulations and suggested that such changes should be adopted, if at all, for disguised sale purposes only. Additionally, one commenter noted that in all but the simplest of partnerships the liquidation value percentage may have little or no relationship to the partners' share of profits and therefore is inconsistent with the general rule for allocating excess nonrecourse liabilities. Another commenter thought the liquidation value percentage approach could be subject to manipulation. Partially in response to commenters' concerns about both the liquidation value percentage and the relationship between the methods and certain rules under § 1.704-2, the final regulations under § 1.752-3 retain the significant item method and the alternative method, but do not adopt the liquidation value percentage approach for determining partners' interests in partnership profits. However, the Treasury Department and the IRS have concluded that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method has been abused by partnerships and their partners for disguised sale purposes under section 707. Therefore, as suggested by some commenters, the final regulations under § 1.752-3 provide that, along with the additional method, the significant item method and the alternative method do not apply for purposes of determining a partner's share of a partnership liability for disguised sale purposes.

In addition to the changes to § 1.752-3, the final regulations revise *Example 1* under § 1.707-5(f) and *Example 2* under § 1.707-6(d) to update some of the cross references to the liability allocation rule in the 707 Temporary Regulations. The final regulations also revise *Examples 5* and *6* under § 1.707-5(f) and *Examples 10* and *12* under proposed § 1.707-5(f) to remove the assumption that the liability is a recourse liability.

Finally, because, under the 707 Temporary Regulations, a partner's share of a partnership liability for disguised sale pur-

poses is based on the partner's share of partnership profits, a partner cannot be allocated 100 percent of the liabilities for purposes of section 707. As a result, some amount of the liabilities, both qualified liabilities and nonqualified liabilities, may shift among partners. The shifting of even a minimal amount of a nonqualified liability that triggers a disguised sale can cause a portion of the qualified liability to be treated as consideration under § 1.707-5(a)(5). Section 1.707-5(a)(5) provides a special rule when a partnership's assumption of, or taking property subject to, a qualified liability is treated as a transfer of consideration made pursuant to a sale due solely to the partnership's assumption of, or taking property subject to, a liability other than a qualified liability. To mitigate the effect of the allocation method for disguised sales, the final regulations include a rule under § 1.707-5(a)(5) that does not take into account qualified liabilities as consideration in transfers of property treated as a sale when the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or \$1,000,000.

### *3. Step-in-the-Shoes Rule Regarding Preformation Capital Expenditures and Liabilities Incurred by Another Person*

For purposes of applying the exception for preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707-5(a)(6), commenters suggested that the final regulations clarify how the rules under §§ 1.707-4(d) and 1.707-5 apply if the transferor partner acquired the transferred property in a nonrecognition transaction, assumed a liability in a nonrecognition transaction, or took property subject to a liability in a nonrecognition transaction from a person who incurred the preformation capital expenditures or the liability. Commenters noted that Rev. Rul. 2000-44 (2000-2 CB 336) allowed "step-in-the-shoes" treatment when a corporation that acquires assets in a transaction described in section 381(a) succeeds to the status of the transferor corporation for purposes of applying the exception for

preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707-5(a)(6). Similar to a corporation that acquires assets in a section 381(a) transaction, a partner that acquires property, assumes a liability, or takes property subject to a liability from another person in connection with certain other nonrecognition transactions should succeed to the status of the other person for purposes of applying the exception for preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707-5(a)(6). Thus, the final regulations provide a "step-in-the-shoes" rule for applying the exception for preformation capital expenditures and for determining whether a liability is a qualified liability under § 1.707-5(a)(6) when a partner acquires property, assumes a liability, or takes property subject to a liability from another person in connection with a nonrecognition transaction under section 351, 381(a), 721, or 731. As a result, Rev. Rul. 2000-44, relating to preformation capital expenditures and qualified liabilities involved in a transaction described in section 381(a), is superseded by these final regulations.

### *4. Anticipated Reduction*

Under the existing regulations, for purposes of the rules under section 707, a partner's share of a liability assumed or taken subject to by a partnership is determined by taking into account certain subsequent reductions in the partner's share of the liability. See § 1.707-5(a)(3) and (b)(2)(iii). The 2014 Proposed Regulations provided that if, within two years of the partnership assuming, taking property subject to, or incurring a liability, a partner's share of the liability is reduced due to a decrease in the partner's or a related person's net value, then the reduction will be presumed to be anticipated and must be disclosed under § 1.707-8, unless the facts and circumstances clearly establish that the decrease in the net value was not anticipated. Because the 707 Temporary Regulations provide that a partner's share of any liability for disguised sale purposes is determined in accordance with the partner's interest in partnership profits under § 1.752-3(a)(3), net value is not relevant in determining a partner's share of part-

nership liabilities for disguised sale purposes. Accordingly, the final regulations do not retain the net value component of the anticipated reduction of share of liabilities rule.

### 5. Tiered Partnerships

The existing regulations in § 1.707-5(e), and § 1.707-6(b) by applying rules similar to § 1.707-5(e), provide only a limited tiered-partnership rule for cases in which a partnership succeeds to a liability of another partnership. The 2014 Proposed Regulations added additional rules regarding tiered partnerships. One rule related to the characterization of liabilities attributable to a contributed partnership interest. Under that proposed rule, a contributing partner's share of a liability from a lower-tier partnership is treated as a qualified liability to the extent the liability would be a qualified liability had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership. The final regulations retain this proposed rule but, in response to comments, address whose intent, the partner's or the lower-tier partnership's, is relevant when applying the anticipated transfer of property rule in § 1.707-5(a)(6) for purposes of determining whether a liability constitutes a qualified liability. The comments suggested that it should be the intent of the partner as to whether the partner anticipated transferring its interest in the lower-tier partnership to the upper-tier partnership at the time the lower-tier partnership incurred the liability.

The Treasury Department and the IRS agree that the intent of the partner is the appropriate inquiry in applying the anticipated transfer of property rule under § 1.707-5(a)(6) in the context of contributions of a partnership interest. Thus, the final regulations provide that in determining whether a liability would be a qualified liability under § 1.707-5(a)(6)(i)(B) or (E), the determination of whether the liability was incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring the partner's interest in the

lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.

Commenters also requested that the final regulations allow for the application of the exception for preformation capital expenditures when a person incurs capital expenditures with respect to property, transfers the property to a partnership (lower-tier partnership), and then transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership) within the two-year period in which the person incurred the capital expenditures. The Treasury Department and the IRS have determined that such a rule is warranted, subject to certain limitations. Therefore, the final regulations provide that, in such circumstances, and provided such expenditures are not otherwise reimbursed to the person, the upper-tier partnership "steps in the shoes" of the person with respect to the property for which the capital expenditures were incurred and may be reimbursed for the capital expenditures by the lower-tier partnership to the same extent that the person could have been reimbursed by the lower-tier partnership. In addition, the person is deemed to have transferred the property, rather than the partnership interest, to the upper-tier partnership for purposes of the exception for preformation capital expenditures and, accordingly, may be reimbursed by the upper-tier partnership to the extent the person could have been previously reimbursed by the lower-tier partnership. The aggregate reimbursements for capital expenditures under this rule cannot exceed the amount that the person could have been reimbursed for such capital expenditures under § 1.707-4(d)(1).

### 6. Treatment of Liabilities in Assets-Over Merger

The 2014 Proposed Regulations extended the netting principles of § 1.752-1(f) in a provision for determining the effect of an assets-over merger or consolidation under the disguised sale rules. Although comments were generally favorable, they did request clarification on the specific rule provided.

Upon further consideration of the area, the Treasury Department and the IRS have determined that no rule on the treat-

ment of liabilities in an assets-over merger is needed in § 1.707-5. In many instances, liabilities involved in such a merger will constitute qualified liabilities, especially given that the final regulations adopt a "step-in-the-shoes" rule for liabilities acquired by a partner from another person in certain nonrecognition transactions. In cases in which liabilities involved in an assets-over merger do not constitute qualified liabilities, the facts and circumstances test in § 1.707-3 should reach the proper result. Thus, the final regulations do not retain the proposed rule for partnership assets-over mergers or consolidations.

### 7. Disguised Sales of Property by a Partnership to a Partner

Under § 1.707-6, rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a disguised sale of property, in whole or in part, to the partner. The Treasury Department and the IRS requested in the preamble to the 2014 Proposed Regulations comments on whether, for purposes of § 1.707-6, it is inappropriate to take into account a transferee partner's share of a partnership liability immediately prior to a distribution if the transferee partner did not have economic exposure with respect to the partnership liability for a meaningful period of time before appreciated property is distributed to that partner subject to the liability. Commenters suggested that § 1.707-6 should be amended to take into account the transitory nature of a partner's share of nonqualified liabilities.

Because under the 707 Temporary Regulations a partner's share of all liabilities is determined for disguised sale purposes in accordance with the partner's interest in partnership profits under § 1.752-3(a)(3), the transitory nature of a partner's share of nonqualified liabilities is no longer an issue. Under that allocation method, an allocation of a 100 percent share of a liability to a partner immediately before a transfer of property by the partnership to the partner in which the transferee partner assumes the liability

will not be taken into account. Therefore, the final regulations do not make any changes to the rules under § 1.707-6, other than revising *Example 2* under § 1.707-6(d) to update a cross reference to the liability allocation rule in the 707 Temporary Regulations.

### Effective/Applicability Dates

With respect to amendments to §§ 1.707-3 through 1.707-6, the final regulations under section 707 apply to any transaction with respect to which all transfers occur on or after October 5, 2016.

With respect to amendments to § 1.752-3, the final regulations under section 752 apply to liabilities that are incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership on or after October 5, 2016, other than liabilities incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership pursuant to a written binding contract in effect prior to that date.

### Effect on Other Documents

The following publication is superseded on October 5, 2016: Rev. Rul. 2000-44 (2000-2 CB 336).

### Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal in that it requires partners to provide information they already maintain or can easily obtain to the IRS. Moreover, it should take a partner no more than 1 hour to satisfy the information requirement in these regulations. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6)

does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Drafting Information

The principal authors of these regulations are Deane M. Burke and Caroline E. Hay of the Office of the Associate Chief Counsel (Passthroughs & Special Industries), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

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

Sections 1.707-2 through 1.707-9 also issued under 26 U.S.C. 707(a)(2)(B).

#### § 1.704-2 [Amended]

Par. 2. Section 1.704-2 is amended by:  
1. Removing the language “and (vii)” in paragraph (d)(2)(ii).

2. Removing the language “*Example* (1)(viii) and (ix)” in paragraph (i)(2) and adding the language “*Example* (1)(vii) and (viii)” in its place.

3. Removing the language “*Example* (1)(viii)” in paragraph (i)(5) and adding the language “*Example* (1)(vii)” in its place.

4. Removing *Example* (1)(vii) in paragraph (m) and redesignating *Examples* (1)(viii) and (ix) as *Examples* (1)(vii) and (viii) respectively.

5. Removing the language “*Example* (1)(viii)” in newly redesignated *Example* (1)(viii) in paragraph (m) and adding the language “*Example* (1)(vii)” in its place.

Par. 3. Section 1.707-0 is amended by:

1. Adding entries for §§ 1.707-4(d)(1), (d)(2) through (4), (d)(4)(i) and (ii), (d)(5) and (6), and (f).

2. Adding entries for §§ 1.707-5(a)(8) and (b)(3).

The additions read as follows:

#### § 1.707-0 Table of contents.

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§ 1.707-4 *Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.*

\*\*\*\*\*

(d) \*\*\*\*\*

(1) In general.

(2) Capital expenditures incurred by another person.

(3) Contribution of a partnership interest with capital expenditures property.

(4) Special rule for qualified liabilities.

(i) In general.

(ii) Anti-abuse rule.

(5) Scope of capital expenditures.

(6) Example.

\*\*\*\*\*

(f) Ordering rule cross reference.

\*\*\*\*\*

§ 1.707-5 *Disguised sales of property to partnership; special rules relating to liabilities.*

(a) \*\*\*\*\*

(8) Liability incurred by another person.

(b) \*\*\*\*\*

(3) Ordering rule.

\*\*\*\*\*

Par. 4. Section 1.707-4 is amended by:

1. Redesignating the text of paragraph (d) introductory text after its subject heading as paragraph (d)(1) and adding a paragraph (d)(1) subject heading.

2. Redesignating paragraph (d)(1) as paragraph (d)(1)(i).

3. Redesignating paragraph (d)(2) introductory text as paragraph (d)(1)(ii).

4. Redesignating paragraph (d)(2)(i) as paragraph (d)(1)(ii)(A).

5. Redesignating paragraph (d)(2)(ii) as paragraph (d)(1)(ii)(B) and revising it.

6. Adding reserved paragraph (d)(1)(ii)(C) and paragraphs (d)(2) through (6) and (f).

The additions and revisions read as follows:

§ 1.707-4 *Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.*

\* \* \* \* \*

(d) \* \* \*

(1) *In general.* \* \* \*

(ii) \* \* \*

(B) Property transferred to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the transfer (the 20-percent limitation). However, the 20-percent limitation of this paragraph (d)(1)(ii)(B) does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner's adjusted basis in the transferred property at the time of the transfer (the 120-percent test). This paragraph (d)(1)(ii)(B) shall be applied on a property-by-property basis, except that a partner may aggregate any of the transferred property under this paragraph (d)(1) to the extent—

(1) The total fair market value of such aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or \$1,000,000;

(2) The partner uses a reasonable aggregation method that is consistently applied; and

(3) Such aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5.

(C) [Reserved].

(2) *Capital expenditures incurred by another person.* For purposes of paragraph (d)(1) of this section, a partner steps in the shoes of a person (to the extent the person was not previously reimbursed under paragraph (d)(1) of this section) with respect to capital expenditures the person incurred with respect to property transferred to the partnership by the partner to the extent the partner acquired the property from the person in a nonrecognition

transaction described in section 351, 381(a), 721, or 731.

(3) *Contribution of a partnership interest with capital expenditures property.* If a person transfers property with respect to which the person incurred capital expenditures (capital expenditures property) to a partnership (lower-tier partnership) and, within the two-year period beginning on the date upon which the person incurred the capital expenditures, transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership) in a nonrecognition transaction under section 721, the upper-tier partnership steps in the shoes of the person who transferred the capital expenditures property to the lower-tier partnership with respect to the capital expenditures that are not otherwise reimbursed to the person. The upper-tier partnership may be reimbursed by the lower-tier partnership under paragraph (d)(1) of this section to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership under paragraph (d)(1) of this section. In addition, for purposes of paragraph (d)(1) of this section, the person is deemed to have transferred the capital expenditures property to the upper-tier partnership and may be reimbursed by the upper-tier partnership under paragraph (d)(1) of this section to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership under paragraph (d)(1) of this section and has not otherwise been previously reimbursed. The aggregate reimbursements for capital expenditures under this paragraph (d)(3) shall not exceed the amount that the person could have been reimbursed for such capital expenditures under paragraph (d)(1) of this section.

(4) *Special rule for qualified liabilities—(i) In general.* For purposes of paragraph (d)(1) of this section, if capital expenditures were funded by the proceeds of a qualified liability defined in § 1.707-5(a)(6)(i) that a partnership assumes or takes property subject to in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership

to the partner exceeds the partner's share of the qualified liability (as determined under § 1.707-5(a)(2), (3), and (4)). Capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under § 1.163-8T or were actually used to fund the capital expenditures, irrespective of the tracing requirements under § 1.163-8T.

(ii) *Anti-abuse rule.* If capital expenditures and a qualified liability are incurred under a plan a principal purpose of which is to avoid the requirements of paragraph (d)(4)(i) of this section, the capital expenditures are deemed funded by the qualified liability.

(5) *Scope of capital expenditures.* For purposes of this section and § 1.707-5, the term *capital expenditures* has the same meaning as the term *capital expenditures* has under the Internal Revenue Code and applicable regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures.

(6) *Example.* The following example illustrates the application of paragraph (d) of this section:

*Example. Intangible treated as separate property.* (i) Z transfers to a partnership a business the material assets of which include a tangible asset and goodwill from the reputation of the business. At the time Z transfers the business to the partnership, the tangible asset has a fair market value of \$550,000 and an adjusted basis of \$450,000. The goodwill is a section 197 intangible with a fair market value of \$100,000 and an adjusted basis of \$0. Z incurred \$130,000 of capital expenditures with respect to improvements to the tangible asset (which amount is reflected in its adjusted basis) one year preceding the transfer. Z would like to be reimbursed by the partnership for the capital expenditures with an amount that qualifies for the exception for reimbursement of preformation expenditures under paragraph (d)(1) of this section.

(ii) Under paragraph (d)(1)(ii)(B) of this section, the 20-percent limitation on reimbursed capital expenditures applies on a property-by-property basis. The 120-percent test also applies on a property-by-property basis. Accordingly, the tangible asset and the goodwill each constitutes a separate property. Z incurred the capital expenditures with respect to the tangible asset only. The \$550,000 fair market value of the tangible asset exceeds 120 percent of Z's \$450,000 adjusted basis in the asset at the time of the transfer (120 percent x \$450,000 = \$540,000). Thus, the 20-percent limitation applies so that the reimbursement of Z's \$130,000 of capital expenditures is limited to 20 percent of the fair market value of the tangible asset, or \$110,000 (20 percent x \$550,000).

\* \* \* \* \*

(f) *Ordering rule cross reference.* For payments or transfers by a partnership to a partner to which the rules under this section and § 1.707-5(b) apply, see the ordering rule under § 1.707-5(b)(3).

Par. 5. Section 1.707-5 is amended by:

1. Revising paragraph (a)(3).
2. Adding paragraph (a)(5)(iii).
3. Revising paragraph (a)(6)(i)(C).
4. Removing “and” at the end of paragraph (a)(6)(i)(D) and adding “or” in its place.
5. Adding paragraph (a)(6)(i)(E).
6. Revising paragraph (a)(7)(ii).
7. Adding paragraph (a)(8).
8. Adding a sentence at the end of paragraph (b)(1).
9. Removing the word “property” in paragraph (b)(2)(i)(A) and adding the word “consideration” in its place.
10. Revising paragraph (b)(2)(iii).
11. Adding paragraph (b)(3).
12. Designating the text of paragraph (e) after its subject heading as paragraph (e)(1) and adding paragraph (e)(2).
13. Revising *Examples 1, 5, 6, and 10* in paragraph (f).
14. Redesignating *Example 11* in paragraph (f) as *Example 13* and adding new *Examples 11 and 12*.

The additions and revisions read as follows:

§ 1.707-5 *Disguised sales of property to partnership; special rules relating to liabilities.*

(a) \* \* \*

(3) *Reduction of partner's share of liability.* For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes property subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(i) At the time that the partnership assumes or takes property subject to the liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced;

(ii) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and

(iii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes mini-

mizing the extent to which the assumption of or taking property subject to the liability is treated as part of a sale under § 1.707-3.

\* \* \* \* \*

(5) \* \* \*

(iii) Notwithstanding paragraph (a)(5)(i) of this section, in connection with a transfer of property by a partner to a partnership that is treated as a sale due solely to the partnership's assumption of or taking property subject to a liability other than a qualified liability, the partnership's assumption of or taking property subject to a qualified liability is not treated as a transfer of consideration made pursuant to the sale if the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or \$1,000,000.

(6) \* \* \*

(i) \* \* \*

(C) A liability that is allocable under the rules of § 1.163-8T to capital expenditures (as described under § 1.707-4(d)(5)) with respect to the property;

\* \* \* \* \*

(E) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a transfer presumed to be in anticipation of the transfer); and

\* \* \* \* \*

(7) \* \* \*

(ii) *Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.* A partner that treats a liability assumed or taken subject to by a partnership in connection with a transfer of property as a qualified liability under paragraph (a)(6)(i)(B) of this section or under paragraph (a)(6)(i)(E) of this section (if the liability was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in

writing to transfer the property or the date the partner transfers the property to the partnership) must disclose such treatment to the Internal Revenue Service in accordance with § 1.707-8.

(8) *Liability incurred by another person.* Except as provided in paragraph (e)(2) of this section, a partner steps in the shoes of a person for purposes of paragraph (a) of this section with respect to a liability the person incurred or assumed to the extent the partner assumed or took property subject to the liability from the person in a nonrecognition transaction described in section 351, 381(a), 721, or 731.

(b) \* \* \*

(1) \* \* \* For purposes of paragraph (b) of this section, an upper-tier partnership's share of the liability of a lower-tier partnership as described under § 1.707-5(a)(2) that is treated as a liability of the upper-tier partnership under § 1.752-4(a) shall be treated as a liability of the upper-tier partnership incurred on the same day the liability was incurred by the lower-tier partnership.

(2) \* \* \*

(iii) *Reduction of partner's share of liability.* For purposes of paragraph (b)(2) of this section, a partner's share of a liability immediately after a partnership incurs the liability is determined by taking into account a subsequent reduction in the partner's share if—

(A) At the time that the partnership incurs the liability, it is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer;

(B) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and

(C) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale.

(3) *Ordering rule.* The treatment of a transfer of money or other consideration under paragraph (b) of this section is determined before applying the rules under § 1.707-4.

\* \* \* \* \*

(e) \* \* \*

(2) If an interest in a partnership that has one or more liabilities (the lower-tier partnership) is transferred to another partnership (the upper-tier partnership), the upper-tier partnership's share of any liability of the lower-tier partnership that is treated as a liability of the upper-tier partnership under § 1.752-4(a) is treated as a qualified liability under paragraph (a)(6)(i) of this section to the extent the liability would be a qualified liability under paragraph (a)(6)(i) of this section had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership. For purposes of determining whether the liability constitutes a qualified liability under paragraphs (a)(6)(i)(B) and (E) of this section, a determination that the liability was not incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring its interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.

(f) \* \* \*

*Example 1. Partnership's assumption of nonrecourse liability encumbering transferred property.* (i) A and B form partnership AB, which will engage in renting office space. A transfers \$500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of \$1,000,000, has an adjusted basis of \$400,000, and is encumbered by a \$500,000 nonrecourse liability, which B incurred 12 months earlier to finance the acquisition of other property and which the partnership assumed. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse liabilities under § 1.752-3(a)(3). The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii)(b).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability as determined under paragraph (a)(2) of this section is \$250,000 (B's 50 percent share of the partnership's excess nonrecourse liability as determined in accordance with B's share of partnership profits under § 1.752-3(a)(3)).

(iii) The partnership's assumption of the liability encumbering the office building is treated as a transfer of \$250,000 of consideration to B (the amount by which the liability (\$500,000) exceeds B's share of that liability immediately after the partnership's assumption of the liability (\$250,000)). B is treated as having sold \$250,000 of the fair market value of the office building to the partnership in exchange for the partnership's assumption of a \$250,000 liability. This results in a gain of \$150,000 (\$250,000 minus \$250,000/\$1,000,000 multiplied by \$400,000).

\* \* \* \* \*

*Example 5. Partnership's assumption of a qualified liability as sole consideration.* (i) F purchases property Z in 2012. In 2017, F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of \$165,000 and an adjusted tax basis of \$75,000. Also, at the time of the transfer, property Z is subject to a \$75,000 nonrecourse liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that immediately after the partnership's assumption of the liability encumbering property Z, F's share of that liability for disguised sale purposes is \$25,000 in accordance with § 1.707-5(a)(2).

(ii) The \$75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the partnership's assumption of the liability and the liability has encumbered property Z for more than two years prior to F's transfer. See paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

*Example 6. Partnership's assumption of a qualified liability in addition to other consideration.* (i) The facts are the same as in *Example 5*, except that the partnership makes a transfer to F of \$30,000 in money that is consideration for F's transfer of property Z to the partnership under § 1.707-3.

(ii) As in *Example 5*, the \$75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred \$30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, assuming no other exception to disguised sale treatment applies to the transfer of the \$30,000, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability (\$50,000 (that is, the excess of the \$75,000 qualified liability over F's \$25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability (\$75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under § 1.707-3(a) (\$30,000 transfer of money); by

(B) F's net equity in property Z (\$90,000 (that is, the excess of the \$165,000 fair market value over the \$75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of \$25,000 (one-third of \$75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold \$55,000 of the fair market value of property Z to the partnership in exchange for \$30,000 in money and the partnership's assumption of \$25,000 of the qualified liability. Accordingly, F must recognize \$30,000 of gain on the sale (the excess of the \$55,000 amount realized over \$25,000 of F's adjusted basis for property Z (that is, one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

\* \* \* \* \*

*Example 10. Treatment of debt-financed transfers of consideration by partnership.* (i) K transfers property Z to partnership KL in exchange for a 50 percent interest therein on April 9, 2017. On September 13, 2017, the partnership incurs a nonrecourse liability of \$20,000. On November 17, 2017, the partnership transfers \$20,000 to K, and \$10,000 of this transfer is allocable under the rules of § 1.163-8T to proceeds of the partnership liability incurred on September 13, 2017. The remaining \$10,000 is paid from other partnership funds. Assume that on November 17, 2017, for disguised sale purposes, K's share of the \$20,000 liability incurred on September 13, 2017, is \$10,000 in accordance with § 1.707-5(a)(2).

(ii) Because a portion of the transfer made to K on November 17, 2017, is allocable under § 1.163-8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707-3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the \$20,000 liability used to fund \$10,000 of the transfer to K is \$5,000 (K's share of the liability (\$10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K (\$10,000); by

(B) The total amount of such liability (\$20,000)).

(iii) Therefore, K is required to take into account \$15,000 of the \$20,000 partnership transfer to K for purposes of this section and § 1.707-3. Under these facts, assuming no other exception applies and the within-two-year presumption is not rebutted, this \$15,000 transfer will be treated under the rule in § 1.707-3 as part of a sale by K of property Z to the partnership.

*Example 11. Treatment of debt-financed transfers of consideration and transfers characterized as guaranteed payments by a partnership.* (i) The facts are the same as in *Example 10*, except that the entire \$20,000

transfer to K is allocable under the rules of § 1.163-8T to proceeds of the partnership liability incurred on September 13, 2017. In addition, the partnership agreement provides that K is to receive a guaranteed payment for the use of K's capital in the amount of \$10,000 in each of the three years following the transfer of property Z. Ten thousand dollars of the transfer made to K on November 17, 2017, is pursuant to this provision of the partnership agreement. Assume that the guaranteed payment to K constitutes a reasonable guaranteed payment within the meaning of § 1.707-4(a)(3).

(ii) Under these facts, the rules under both § 1.707-4(a) and § 1.707-5(b) apply to the November 17, 2017 transfer to K by the partnership. Thus, the ordering rule in § 1.707-5(b)(3) requires that the § 1.707-5(b) debt-financed distribution rules apply first to determine the treatment of the \$20,000 transfer. Because the entire transfer made to K on November 17, 2017, is allocable under § 1.163-8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707-3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the \$20,000 liability used to fund the transfer to K is \$10,000 (K's share of the liability (\$10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K (\$20,000); by

(B) The total amount of such liability (\$20,000)).

(iii) The remaining \$10,000 amount of the transfer to K that exceeds K's allocable share of the liability is tested to determine whether an exception under § 1.707-4 applies. Because \$10,000 of the payment to K is a reasonable guaranteed payment for capital under § 1.707-4(a)(1)(ii), the \$10,000 transfer will not be treated as part of a sale by K of property Z to the partnership under § 1.707-3.

*Example 12. Treatment of debt-financed transfers of consideration by partnership made pursuant to plan.* (i) O transfers property X, and P transfers property Y, to partnership OP in exchange for equal interests therein on June 1, 2017. On October 1, 2017, the partnership incurs two nonrecourse liabilities: Liability 1 of \$8,000 and Liability 2 of \$4,000. On December 15, 2017, the partnership transfers \$2,000 to each of O and P pursuant to a plan. The transfers made to O and P on December 15, 2017 are allocable under § 1.163-8T to the proceeds of either Liability 1 or Liability 2. Assume that under § 1.707-5(a)(2), O's and P's share of Liability 1 is \$4,000 each and of Liability 2 is \$2,000 each on December 15, 2017.

(ii) Because the partnership transferred pursuant to a plan a portion of the proceeds of the two liabilities to O and P, paragraph (b)(1) of this section is applied by treating Liability 1 and Liability 2 as a single \$12,000 liability. Pursuant to paragraph (b)(2)(ii)(A) of this section, each partner's allocable share of the \$12,000 liability equals the amount obtained by multiplying the sum of the partner's share of Liability 1 and Liability 2 (\$6,000) (\$4,000 for Liability 1 plus \$2,000 for Liability 2) by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to O and P pursuant to the plan (\$4,000); by

(B) The total amount of such liability (\$12,000).

(iii) Therefore, O's and P's allocable share of the \$12,000 liability is \$2,000 each. Accordingly, because a portion of the proceeds of the \$12,000 liability are allocable under § 1.163-8T to the \$2,000 transfer made to each of O and P within 90 days of incurring the liability, and the \$2,000 transfer does not exceed O's or P's \$2,000 allocable share of that liability, each is required to take into account \$0 of the \$2,000 transfer for purposes of this section and § 1.707-3. Under these facts, no part of the transfers to O and P will be treated as part of a sale of property X by O or of property Y by P.

\* \* \* \* \*

Par. 6. Section 1.707-6 is amended by revising *Example 2(i)* in paragraph (d) to read as follows:

*§ 1.707-6 Disguised sales of property by partnership to partner; general rules.*

\* \* \* \* \*

(d) \* \* \* \*

*Example 2. Assumption of liability by partner.* (i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of \$1,000,000 and is encumbered by a nonrecourse liability of \$600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that under § 1.707-5(a)(2), B's share of the nonrecourse liability immediately before the transfer of property Y was \$100,000.

\* \* \* \* \*

Par. 7. Section 1.707-9 is amended by revising paragraph (a)(1) to read as follows:

*§ 1.707-9 Effective dates and transitional rules.*

(a) \* \* \* \*

(1) *In general.* Except as otherwise provided in this paragraph (a), §§ 1.707-3 through 1.707-6 apply to any transaction with respect to which all transfers occur on or after October 5, 2016. For any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991, but before October 5, 2016, §§ 1.707-3 through 1.707-6 as contained in 26 CFR part 1 revised as of April 1, 2016, apply.

\* \* \* \* \*

Par. 8. Section 1.752-3 is amended by:

1. Revising the third, fourth, fifth, and sixth sentences in paragraph (a)(3).

2. Adding paragraph (d).

The revisions and addition read as follows:

*§ 1.752-3 Partner's share of nonrecourse liabilities.*

(a) \* \* \* \*

(3) \* \* \* \* The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (significant item method). Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property (additional method). The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2).

\* \* \* \* \*

(d) *Effective/applicability dates.* The third, fourth, fifth, and sixth sentences of paragraph (a)(3) of this section apply to liabilities that are incurred, taken subject to, or assumed by a partnership on or after October 5, 2016, other than liabilities incurred, taken subject to, or assumed by a partnership pursuant to a written binding contract in effect prior to October 5, 2016. For liabilities that are incurred, taken subject to, or assumed by a partnership before October 5, 2016, the third, fourth, fifth, and sixth sentences of paragraph (a)(3) of this section as contained in 26 CFR part 1 revised as of April 1, 2016, apply.

John Dalrymple,  
Deputy Commissioner  
for Services and Enforcement.

Approved: August 29, 2016.

Mark M. Mazur,  
Assistant Secretary of  
the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on October 4, 2016, 8:45 a.m., and published in the issue of the Federal Register for October 5, 2016, 81 F.R.69291)

26 CFR 1.707-5T; 1.707-9T; and 1.752-2T: *Liabilities Recognized as Recourse Partnership Liabilities Under Section 752.*

## T.D. 9788

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### Liabilities Recognized as Recourse Partnership Liabilities Under Section 752

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

**SUMMARY:** This document contains final and temporary regulations concerning how liabilities are allocated for purposes of section 707 of the Internal Revenue Code (Code) and when certain obligations are recognized for purposes of determining whether a liability is a recourse partnership liability under section 752. These regulations affect partnerships and their partners. The text of these temporary regulations serves as part of the text of proposed regulations (REG-122855-15) published in the Proposed Rules section in this issue of the **Bulletin**.

**DATES:** *Effective date:* These regulations are effective on October 5, 2016.

*Applicability dates:* For dates of applicability, see §§ 1.707-9T(a)(4) and 1.752-2T(1)(2).

**FOR FURTHER INFORMATION CONTACT:** Concerning the final and temporary regulations, Caroline E. Hay or

Deane M. Burke, (202) 317-5279 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:** In addition to these final and temporary regulations, the Treasury Department and the IRS are publishing in the Rules and Regulations section in this issue of the **Bulletin**, final regulations under section 707 concerning disguised sales and under section 752 regarding the allocation of excess nonrecourse liabilities of a partnership to a partner, and, in the Proposed Rules section in this issue of the **Bulletin**, proposed regulations (REG-122855-15) that incorporate the text of these temporary regulations, withdraw a portion of a notice of proposed rulemaking (REG-119305-11) to the extent not adopted by the final regulations, and contain new proposed regulations addressing (1) when certain obligations to restore a deficit balance in a partner's capital account are disregarded under section 704 and (2) when partnership liabilities are treated as recourse liabilities under section 752.

#### Paperwork Reduction Act

The collection of information related to these final and temporary regulations under section 752 is reported on Form 8275, Disclosure Statement, and has been reviewed in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and approved by the Office of Management and Budget under control number 1545-0889.

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Bulletin**.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and

tax return information are confidential, as required by section 6103.

#### Background

##### 1. Overview

This Treasury decision contains final and temporary regulations that amend the Income Tax Regulations (26 CFR part 1) under sections 707 and 752 of the Code. On January 30, 2014, the Treasury Department and the IRS published a notice of proposed rulemaking in the **Federal Register** (REG-119305-11, 79 FR 4826) to amend the then existing regulations under section 707 relating to disguised sales of property to or by a partnership and under section 752 concerning the treatment of partnership liabilities (the 2014 Proposed Regulations). The 2014 Proposed Regulations provided certain technical rules intended to clarify the application of the disguised sale rules under section 707 and also contained rules regarding the sharing of partnership recourse and nonrecourse liabilities under section 752.

A public hearing on the 2014 Proposed Regulations was not requested or held, but the Treasury Department and the IRS received written comments.

Based on a comment received on the 2014 Proposed Regulations requesting that guidance provided under section 752 regarding a partner's share of partnership liabilities apply instead solely for disguised sale purposes, the Treasury Department and the IRS have reconsidered the rules under § 1.707-5(a)(2) of the 2014 Proposed Regulations for determining a partner's share of partnership liabilities for purposes of section 707. Accordingly and as recommended by that commenter, this Treasury decision contains temporary regulations under section 707 (the 707 Temporary Regulations) that require a partner to apply the same percentage used to determine the partner's share of excess nonrecourse liabilities under § 1.752-3(a)(3) (with certain limitations) in determining the partner's share of partnership liabilities for disguised sale purposes. This Treasury decision also contains temporary regulations under section 752 (the 752 Temporary Regulations) providing guidance on the treatment of "bottom dollar payment obligations." Cross-referencing

proposed regulations providing additional opportunity for comment are contained in the related notice of proposed rulemaking (REG-122855-15) published in the Proposed Rules section in this issue of the **Bulletin**. The Summary of Comments and Explanation of Provisions section of the preamble of this Treasury decision discusses the changes for determining a partner's share of partnership liabilities for disguised sale purposes and also the rules relating to certain "bottom dollar payment obligations."

The Treasury Department and the IRS are also publishing final regulations under section 707 (the 707 Final Regulations) in a separate Treasury decision (TD 9787) published in the Rules and Regulations section in this issue of the **Bulletin** that adopt the remaining provisions of the 2014 Proposed Regulations under section 707. That Treasury decision also contains final regulations under section 752 (the 752 Final Regulations) concerning the allocation of a partnership's excess nonrecourse liabilities as explained in the Summary of Comments and Explanation of Provisions sections of that Treasury decision.

Finally, after considering comments on the 2014 Proposed Regulations under section 752, the Treasury Department and the IRS are withdrawing proposed § 1.752-2 and are issuing new proposed regulations (the 752 Proposed Regulations) contained in the related notice of proposed rulemaking (REG-122855-15) published in the Proposed Rules section in this issue of the **Bulletin**.

## 2. Summary of Applicable Law

In determining a partner's share of a partnership liability for disguised sale purposes, the existing regulations under section 707 prescribe separate rules for a partnership's recourse liability and a partnership's nonrecourse liability. Under § 1.707-5(a)(2)(i), a partner's share of a partnership's recourse liability equals the partner's share of the liability under section 752 and the regulations thereunder. A partnership liability is a recourse liability under section 707 to the extent that the obligation is a recourse liability under § 1.752-1(a)(1). Under § 1.707-5(a)(2)(ii), a partner's share of a partnership's

nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3). Generally, a partner's share of the excess nonrecourse liability is determined in accordance with the partner's share of partnership profits taking into account all facts and circumstances relating to the economic arrangement of the partners. A partnership liability is a nonrecourse liability under section 707 to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2). In addition, the existing regulations under section 707 provide that a partnership liability is a recourse or nonrecourse liability to the extent the liability would be recourse under § 1.752-1(a)(1) or nonrecourse under § 1.752-1(a)(2), respectively, if the liability was treated as a partnership liability for purposes of section 752 (§ 1.752-7 contingent liabilities).

Section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that a partner or related person bears the economic risk of loss (EROL) for that liability under § 1.752-2. Section 1.752-2(a) provides that a partner's share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the EROL. Section 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability under § 1.752-2. A partner generally bears the EROL for a partnership liability if the partner or related person has an obligation to make a payment under § 1.752-2(b). A partner generally has an obligation to make a payment to the extent that the partner or related person would have to make a payment if, upon a constructive liquidation of the partnership, the partnership's assets were worthless and the liability became due and payable (constructive liquidation test). Section 1.752-2(b)(6) presumes partners and related persons will satisfy their payment obligations irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

## Summary of Comments and Explanation of Provisions

### 1. Partner's Share of Partnership Liabilities for Purposes of Section 707

The withdrawn portions of the 2014 Proposed Regulations included proposed changes to § 1.752-2 that were intended to ensure that only genuine commercial payment obligations, including guarantees and indemnities, affected the allocation of partnership liabilities. Although the 2014 Proposed Regulations received some unfavorable comments, one commenter expressed support for the overall objective of those proposed rules. According to the commenter, the clear effect of the 2014 Proposed Regulations under section 752 was to make it more likely that liabilities would be treated as nonrecourse liabilities, and thus allocable under § 1.752-3. The commenter noted that such an effect seems appropriate as an economic matter, because, contrary to the constructive liquidation test in § 1.752-2(b)(1), lenders, borrowers, and credit support providers generally do not expect that the assets of the partnership will become worthless. Rather, lenders, borrowers and credit support providers generally expect borrowers (including partnerships) to satisfy their obligations (in the case of a partnership, with partnership profits). However, the commenter expressed concerns with the proposed section 752 rules. The commenter suggested that the regulations adopt a more narrowly tailored approach that treats all liabilities as nonrecourse liabilities for section 707 disguised sale purposes only.

Other commenters also suggested that changes to the liability allocation rules be limited to the context of disguised sales under section 707 to specifically address the abuses that concern the Treasury Department and the IRS. One abuse relating to disguised sales within the meaning of § 1.707-3 concerns the debt-financed distribution exception under § 1.707-5(b). Under this exception, a distribution of money to a partner by a partnership is not taken into account for purposes of § 1.707-3 to the extent that the distribution is traceable to a partnership borrowing and the amount of the distribution does not exceed the partner's allocable

share of the liability incurred to fund the distribution. The legislative history to section 707, upon which the debt-financed distribution exception in § 1.707-5(b) is based, contemplates a contributing partner borrowing through the partnership rather than engaging in a disguised sale when the partner, in substance, retains liability for repayment of the borrowed amounts. See H.R. Rep. No. 861, 98th Cong., 2d Sess. 859 (1984). This exception, however, has been abused through leveraged partnership transactions in which the contributing partners or related persons enter into payment obligations that are not commercial solely to achieve an allocation of the partnership liability to the partner, with the objective of avoiding a disguised sale. See, for example, *Canal Corp. v. Commissioner*, 135 T.C. 199, 216 (2010) (“We have carefully considered the facts and circumstances and find that the indemnity agreement should be disregarded because it created no more than a remote possibility that [the indemnitor] would actually be liable for payment.”).

After considering the comments on the 2014 Proposed Regulations suggesting that the regulations be narrowly tailored to address abuse concerns relating to disguised sales, the Treasury Department and the IRS have concluded that, for disguised sale purposes only, it is appropriate for partners to determine their share of any partnership liability, whether recourse or nonrecourse under section 752, in the manner in which excess nonrecourse liabilities are allocated under § 1.752-3(a)(3), as limited for disguised sale purposes in the 752 Final Regulations. For purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners more accurately than the current regulations or the 2014 Proposed Regulations. In most cases, a partnership will satisfy its liabilities with partnership profits, the partnership’s assets do not become worthless, and the payment obligations of partners or related persons are not called upon. This is true whether: (1) a partner’s liability is assumed by a partnership in connection with a transfer of property to the partnership or by a partner in connection with a transfer of property by the partnership to the partner; (2) a partnership takes property subject to a liability in connection

with a transfer of property to the partnership or a partner takes property subject to a liability in connection with a transfer of property by the partnership to the partner; or (3) a liability is incurred by the partnership to make a distribution to a partner under the debt-financed distribution exception in § 1.707-5(b). Accordingly, under the 707 Temporary Regulations, a partner’s share of any partnership liability for disguised sale purposes is the same percentage used to determine the partner’s share of the partnership’s excess nonrecourse liabilities under § 1.752-3(a)(3), as limited for disguised sale purposes under the 752 Final Regulations.

Commenters also suggested that a partner’s share of a partnership liability for disguised sale purposes should not include any portion of the liability for which another partner bears the EROL, as these liabilities would not be allocated to a partner without EROL under general principles of subchapter K. The Treasury Department and the IRS agree with the commenter that this change should not create a liability allocation not otherwise allowed under general subchapter K principles. Therefore, the 707 Temporary Regulations provide that for purposes of § 1.707-5, a partner’s share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner’s share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to § 1.707-5T(a)(2)), but such share shall not exceed the partner’s share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to § 1.707-5T(a)(2)).

The liability allocation approach for disguised sale purposes in the 707 Temporary Regulations does not conflict with Congress’s directive relating to section 752, which had been raised as a potential concern by some commenters with respect to the 2014 Proposed Regulations. Section 79 of the Deficit Reduction Act of 1984 (Public Law 98-369) overruled the decision in *Raphan v. United States*, 3 Cl. Ct. 457 (1983) (holding that a guarantee by a general partner of an otherwise nonrecourse liability of the partnership did not require the partner to be treated as person-

ally liable for that liability) and directed the Secretary of the Treasury to amend the regulations under section 752 to reflect the overruling of the *Raphan* decision. At issue in the *Raphan* case was debt allocation under section 752; accordingly, Congress’s directive related to regulations under section 752 only. As noted, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for purposes of section 707. Thus, the approach adopted in the 707 Temporary Regulations does not conflict with the approach directed by Congress after the *Raphan* case.

Finally, in addition to the rule for determining a partner’s share of a § 1.752-1(a) partnership liability for disguised sale purposes, the 707 Temporary Regulations reserve with respect to the treatment of § 1.752-7 contingent liabilities for disguised sale purposes. The 2014 Proposed Regulations proposed removing the “would be treated” language in § 1.707-5(a)(2)(i) and (ii) of the existing regulations relating to contingent liabilities. The 707 Temporary Regulations replace the proposed provisions with the previously discussed rule for determining a partner’s share of a partnership liability as defined in § 1.752-1(a). Because the 2014 Proposed Regulations would have removed language relating to § 1.752-7 contingent liabilities, some commenters suggested that the regulations specifically clarify how contingent liabilities are treated for purposes of the disguised sale rules. The Treasury Department and the IRS agree that clarification of the treatment of § 1.752-7 contingent liabilities for disguised sale purposes is warranted.

In many cases, § 1.752-7 contingent liabilities may constitute qualified liabilities that would not be taken into account for purposes of determining a disguised sale. However, some commenters noted that there may be circumstances in which certain transfers of § 1.752-7 contingent liabilities to a partnership may be abusive. Thus, the Treasury Department and the IRS will continue to study the issue of the effect of contingent liabilities with respect to section 707, as well as other sections of the Code, in connection with future guidance projects.

## 2. Determining Whether a Liability Is a Recourse Liability of a Partnership

The 752 Temporary Regulations amend § 1.752-2 to address certain payment obligations of a partner or related person. The Treasury Department and the IRS continue to have concerns that partners and related persons are entering into payment obligations that are not commercial solely to achieve an allocation of a partnership liability.

Under the 2014 Proposed Regulations, a partner's or related person's payment obligation with respect to a partnership liability would not have been recognized under § 1.752-2(b)(3) unless seven factors (recognition factors) were satisfied. Two of the seven recognition factors imposed certain additional requirements on contractual obligations outside a partnership agreement, such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, other partners, or to the partnership (guarantee and indemnity recognition factors). In the case of a guarantee or similar arrangement, the 2014 Proposed Regulations would have required the partner or related person to be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. In the case of an indemnity, reimbursement agreement, or similar arrangement, the 2014 Proposed Regulations would have required the partner or related person to be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefited party's payment obligation is satisfied. The terms of the guarantee, indemnity, or reimbursement agreement would be treated as modified by any right of indemnity, reimbursement agreement, or similar arrangement. However, a right of proportionate contribution running between partners or related persons who were co-obligors with respect to a payment obligation for which each of them was jointly and severally liable would not modify a guarantee, indemnity, or reimbursement agreement. If the partner's or related person's payment obligation failed to satisfy any of the recognition factors,

the payment obligation was not recognized and the partner would not bear EROL for the partnership liability.

In addition to the guarantee and indemnity recognition factors, a partner's or related person's payment obligation with respect to a partnership liability would not be recognized under an anti-abuse rule in the 2014 Proposed Regulations if the facts and circumstances indicated that the partnership liability was part of a plan or arrangement involving the use of tiered partnerships, intermediaries, or similar arrangements to convert a single liability into multiple liabilities with a principal purpose of circumventing the guarantee and indemnity recognition factors.

The Treasury Department and the IRS continue to believe that certain obligations, such as certain so-called "bottom-dollar guarantees," should generally not be recognized as payment obligations under § 1.752-2(b)(3) because they generally lack a significant non-tax commercial business purpose. No commenters suggested that bottom-dollar guarantees were relevant to loan risk underwriting. Accordingly, the 752 Temporary Regulations retain the restriction on certain guarantees and indemnities and provide that these payment obligations are not recognized under § 1.752-2(b)(3). In addition, these regulations remove the *Example* in § 1.752-2(j)(4) to comport with the provisions in the 752 Temporary Regulations relating to bottom dollar payment obligations. However, after considering the comments received on the 2014 Proposed Regulations, the 752 Temporary Regulations provide for an exception as well as an anti-abuse rule to address arrangements that are not intended to be subject to this rule.

### A. General rule: bottom dollar payment obligations

Although the 752 Temporary Regulations retain the restriction relating to certain guarantees and indemnities, these temporary regulations refine the description of non-commercial obligations in response to comments. Commenters expressed concerns with the 2014 Proposed Regulations' description of so-called "bottom-dollar guarantees and indemnities." Commenters thought the language

was confusing. In addition, with respect to the anti-abuse rule in the 2014 Proposed Regulations, one commenter believed that "tranches" of debt could be used to effect arrangements that are economically similar to "bottom-dollar guarantees" and recommended that the regulations strengthen the anti-abuse rule. This commenter suggested that two or more liabilities be treated as a single liability if: (1) the liabilities are incurred pursuant to a common plan, as part of a single transaction, or as part of a series of related transactions; (2) the liabilities have the same counterparty or counterparties (or substantially the same group of counterparties); or (3) the guarantee or similar arrangement would fail the guarantee recognition factor if the liabilities were treated as a single liability; and (4) multiple liabilities (rather than a single liability) were incurred with a principal purpose of avoiding the guarantee recognition factor.

In response to comments, the 752 Temporary Regulations clarify the description of so-called "bottom-dollar guarantees and indemnities" by consolidating these non-commercial obligations under one term: bottom-dollar payment obligations. In addition, instead of having an anti-abuse rule to address arrangements that use tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements, the 752 Temporary Regulations define these arrangements as bottom dollar payment obligations if certain factors, taking into account the commenter's suggestion, exist. Therefore, under the 752 Temporary Regulations, the term "bottom dollar payment obligation" includes (subject to certain exceptions): (1) any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that (A) any amount of the partnership liability is not otherwise satisfied in the case of an obligation that is a guarantee or other similar arrangement, or (B) any amount of the indemnitee's or benefited party's payment obligation is satisfied in the case of an obligation which is an indemnity or similar arrangement; and (2) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or sim-

ilar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred (A) pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and (B) with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation. Any payment obligation under § 1.752-2, including an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(b)(3), may be a bottom dollar payment obligation if it meets the requirements set forth above.

The preamble of the 2014 Proposed Regulations requested comments on whether and under what circumstances regulations should permit recognition of a payment obligation for a portion, rather than 100 percent, of each dollar of a partnership liability to which the payment relates (a “vertical slice” of a partnership liability). The commenters believed that regulations under section 752 should recognize a vertical slice of a partnership liability because these payment obligations represent the same economic risk as a guarantee, for example, of the entire partnership liability.

The Treasury Department and the IRS agree with the commenters that certain obligations, including a vertical slice of a partnership liability, should not cause a payment obligation to be a bottom dollar payment obligation and, thus, not recognized under § 1.752-2(b)(3). In addition, the Treasury Department and the IRS have determined that, as long as a partner or related person is or would be liable for the full amount of a payment obligation, such obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner’s or related person’s obligation. Accordingly, the 752 Temporary Regulations specifically except certain payment obligations within those parameters, including obligations with joint and several liability, from being treated as bottom dollar payment obligations.

### *B. Exception from treatment as a bottom dollar payment obligation*

In addition to comments relating to the description of “bottom-dollar guarantees” and the anti-abuse rule in the 2014 Proposed Regulations, commenters expressed concerns that the guaranty and indemnity recognition factors would deprive a partner from being allocated a liability even in situations where there is real EROL. One commenter described the 2014 Proposed Regulations as prejudging all payment obligations to be remote and fictitious if the obligations did not cover 100 percent of any shortfall in repayment. The commenter believed EROL could exist even if 100 percent of the liability was not covered.

Another commenter appreciated the merits of a bright-line rule that would look to every dollar of a liability, but thought that the 100 percent threshold was too high. This commenter recommended that a payment obligation should be respected if a partner or related person (i) is or would be liable up to the full amount of such partner’s or related person’s payment obligation if, and to the extent that, less than 80 percent of the partnership liability is not otherwise satisfied and (ii) either (A) the taxpayer or the IRS clearly establishes that the credit support materially decreased the partnership’s borrowing costs with respect to the liability or materially enhanced the other terms of the borrowing, or (B) the partners (or persons related to one or more of the partners), in the aggregate, are or would be liable up to the full amount of their payment obligations if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. The commenter believed that this lower threshold incorporates the idea that a person may have meaningful risk with respect to the underlying liability, while protecting the legitimate interests of the government in ensuring that the lower threshold is not abused by taxpayers.

The Treasury Department and the IRS recognize that, in certain circumstances, it might be appropriate to treat a partner as bearing EROL with respect to a payment obligation that would be characterized as a bottom dollar payment obligation under the general rule. What otherwise would be a bottom dollar payment obligation can be

distinguished in a situation where the partners have allocated the risk among themselves, and the person making the bottom dollar payment obligation is liable for at least 90 percent of the person’s payment obligation (because the person is not entitled to indemnification or reimbursement for more than 10 percent of the person’s payment obligation). For example, if one partner (Partner A) guarantees 100 percent of a partnership liability and another partner (Partner B) indemnifies Partner A for the first one percent of Partner A’s obligation, Partner A’s obligation would be characterized as a bottom dollar payment obligation under the general rule because Partner A would not be liable to the full extent of the guarantee if any amount of the partnership liability is not otherwise satisfied (because Partner A would be reimbursed due to Partner B’s indemnity). To address this concern, the 752 Temporary Regulations provide an exception if a partner or related person has a payment obligation that would be recognized (initial payment obligation) under § 1.752-2T(b)(3) but for the effect of an indemnity, reimbursement agreement, or similar arrangement. Such bottom dollar payment obligation is recognized under § 1.752-2T(b)(3) if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the initial payment obligation. This obligation, like any other payment obligation, must otherwise be recognized under § 1.752-2, including under the anti-abuse rules in § 1.752-2(j).

### *C. Anti-abuse rule*

Some commenters noted that partners could manipulate contractual arrangements to achieve a federal income tax result that is not consistent with the economics of an arrangement. For example, a partner could deliberately fail one of the recognition factors in the 2014 Proposed Regulations (including the guarantee or indemnity recognition factor) to cause a partnership liability to be treated as non-recourse even when one partner has true EROL. Just as the 752 Temporary Regulations provide an exception for certain obligations that meet the definition of a bottom dollar payment obligation but give

rise to EROL, the 752 Temporary Regulations also provide an anti-abuse rule in § 1.752-2T(j)(2) that the Commissioner may apply to ensure that if a partner actually bears EROL for a partnership liability, partners may not agree among themselves to create a bottom dollar payment obligation so that the liability will be treated as nonrecourse.

Section 1.752-2(j)(2) of the existing regulations currently provides that, irrespective of the form of a contractual obligation, a partner is considered to bear the EROL with respect to a partnership liability, or a portion thereof, to the extent that: (A) the partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan; (B) the contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and (C) one of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests. The 752 Temporary Regulations expand § 1.752-2(j)(2) to include situations in which a partner is considered to bear the EROL irrespective of a bottom dollar payment obligation.

#### D. Disclosure requirement

The 752 Temporary Regulations require the partnership to disclose to the IRS all bottom dollar payment obligations with respect to a partnership liability on a completed Form 8275, Disclosure Statement, attached to the partnership return for the taxable year in which the bottom dollar payment obligation is undertaken or modified. That disclosure must identify the payment obligation with respect to which disclosure is made including the amount of the payment obligation and the parties to the payment obligation. If a bottom dollar payment obligation meets the exception, the partnership must also disclose to the IRS on Form 8275 the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation and, but for an indemnity, reimbursement

agreement, or similar arrangement, the partner's or related person's payment obligation would have been recognized.

#### Effective/Applicability Date

With respect to changes under § 1.707-5, the 707 Temporary Regulations apply to any transaction with respect to which all transfers occur on or after January 3, 2017. In addition, with respect to the changes under § 1.752-2, the 752 Temporary Regulations apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.

The 2014 Proposed Regulations provided for an effective date similar to the one in these final and temporary regulations. A commenter recommended that partnerships be permitted to elect to apply all, but not less than all, of the provisions of the final regulations to all of its liabilities and payment obligations with respect to its liabilities after the effective date of the final regulations. These 752 Temporary Regulations adopt that change; therefore, partnerships may apply all the provisions contained in the 752 Temporary Regulations to all of their liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016.

Commenters on the 2014 Proposed Regulations also recommended that partnership liabilities or payment obligations that are modified or refinanced continue to be subject to the provisions of the existing regulations to the extent of the amount and duration of the pre-modification (or refinancing) liability or payment obligation. The 752 Temporary Regulations do not adopt this recommendation as the terms of the partnership liabilities and payment obligations could be changed, which would affect the determination of whether or not an obligation is a bottom dollar payment obligation.

The 752 Temporary Regulations do, however, provide transition relief for any partner whose allocable share of partnership liabilities under § 1.752-2 exceeds its adjusted basis in its partnership interest on

the date the temporary regulations are finalized. Under this transitional relief, the partner can continue to apply the existing regulations under § 1.752-2 with respect to a partnership liability for a seven-year period to the extent that the partner's allocable share of partnership liabilities exceeds the partner's adjusted basis in its partnership interest on October 5, 2016. The amount of partnership liabilities subject to transitional relief will be reduced for certain reductions in the amount of liabilities allocated to that partner under the transition rules and, upon the sale of any partnership property, for any tax gain (including section 704(c) gain) allocated to the partner less that partner's share of amount realized.

#### Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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.

Although the temporary regulations under sections 707 and 752 respond to comments received in response to the 2014 Proposed Regulations, the Treasury Department and the IRS have determined that the regulations would benefit from additional notice and comment instead of being published as final regulations. In addition, decisions made in the final regulations under section 707 contained in a separate Treasury decision (TD 9787) published in the Rules and Regulations section in this issue of the **Bulletin** interact with the changes in the 707 Temporary Regulations regarding how liabilities are allocated for disguised sale purposes. Finally, pursuant to authority under section 7805(b) of the Code, the temporary regulations under sections 707 and 752 are necessary to address particular abuses as described in the Summary of Comments and the Explanation of Provisions section of the preamble of this Treasury decision. For these reasons, good cause also exists pursuant to 5 U.S.C. 553 to issue temporary regulations.

For applicability of the Regulatory Flexibility Act, please refer to the cross-

referencing notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Bulletin**. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Drafting Information

The principal authors of these regulations are Caroline E. Hay and Deane M. Burke of the Office of the Associate Chief Counsel (Passthroughs & Special Industries), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

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

Sections 1.707-2 through 1.707-9 also issued under 26 U.S.C. 707(a)(2)(B).

Par. 2. Section 1.707-5 is amended by revising paragraph (a)(2) and *Examples 2, 3, 7, and 8* in paragraph (f) to read as follows:

*§ 1.707-5 Disguised sales of property to partnership; special rules relating to liabilities.*

(a) \* \* \*

(2) [Reserved]. For further guidance, see § 1.707-5T(a)(2).

\* \* \* \* \*

(f) \* \* \*

*Example 2.* [Reserved]. For further guidance, see § 1.707-5T(f) *Example 2*.

*Example 3.* [Reserved]. For further guidance, see § 1.707-5T(f) *Example 3*.

\* \* \* \* \*

*Example 7.* [Reserved]. For further guidance, see § 1.707-5T(f) *Example 7*.

*Example 8.* [Reserved]. For further guidance, see § 1.707-5T(f) *Example 8*.

\* \* \* \* \*

Par. 3. Section 1.707-5T is added to read as follows:

*§ 1.707-5T Disguised sales of property to partnership; special rules relating to liabilities (temporary).*

(a)(1) [Reserved]. For further guidance, see § 1.707-5(a)(1).

(2) *Partner's share of liability*—(i) *In general.* For purposes of § 1.707-5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)), but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)).

(ii) *Partner's share of § 1.752-7 liability.* [Reserved].

(a)(3) through (e) [Reserved]. For further guidance, see § 1.707-5(a)(3) through (e).

(f) *Example 1* [Reserved]. For further guidance, see § 1.707-5(f) *Example 1*.

*Example 2. Partnership's assumption of recourse liability encumbering transferred property.* (i) C transfers property Y to a partnership in which C has a 50 percent interest. At the time of its transfer to the partnership, property Y has a fair market value of \$10,000,000 and is subject to an \$8,000,000 liability that C incurred and guaranteed, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership the partnership assumed the liability encumbering that property. Under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is \$8,000,000.

(ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability. Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership. Notwithstanding C's share of the liability for section 752 purposes, for disguised sale purposes, C's share of the liability immediately after the partnership's assumption is \$4,000,000 (50 percent of \$8,000,000) under paragraph (a)(2) of this section (which determines a partner's share of a liability using the percentage under § 1.752-3(a)(3)). Therefore, the amount of consideration to C is \$4,000,000 (the excess of the liability assumed by the partnership (\$8,000,000) over C's share of the liability for purposes of § 1.707-5(a) immediately after the assumption (\$4,000,000)). See § 1.707-5(a)(1) and paragraph (a)(2) of this section.

*Example 3. Subsequent reduction of transferring partner's share of liability.* (i) The facts are the same as in *Example 2*. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under paragraph (a)(2) of this section will be reduced to \$2,000,000 because of a shift in the allocation of partnership profits pursuant to the terms of the partnership agreement which provide that C's share of the partnership profits will be 25 percent at that time. Under the partnership agreement, this shift in the allocation of partnership profits is dependent solely on the passage of time.

(ii) Under § 1.707-5(a)(3), if the reduction in C's share of the liability was anticipated at the time of C's transfer, was not subject to the entrepreneurial risks of partnership operations, and was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under § 1.707-3 (that is, a principal purpose of allocating a larger percentage of profits to C in the first three years when profits were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the partnership's assumption is treated as equal to C's reduced share of \$2,000,000. Therefore, the amount of consideration to C is \$6,000,000 (the excess of the liability assumed by the partnership (\$8,000,000) over C's share of the liability for purposes of § 1.707-5(a) immediately after the assumption (\$2,000,000)), taking into account the anticipated reduction in C's share of the liability pursuant to the terms of the partnership agreement. See § 1.707-5(a)(1) and (3) and paragraph (a)(2) of this section.

*Examples 4 through 6* [Reserved]. For further guidance, see § 1.707-5(f) *Examples 4 through 6*.

*Example 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan.* (i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for a one-third interest each in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of \$10,000 and an adjusted tax basis of \$6,000, and property 2 has a fair market value of \$10,000 and an adjusted tax basis of \$4,000. At the time properties 1 and 2 are transferred to the partnership, a \$6,000 nonrecourse liability (liability 1) is secured by property 1 and a \$9,000 recourse liability of H (liability 2) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes property 1 subject to liability 1 and assumes liability 2. After the transfer of liability 2 to the partnership, H bears the economic risk of loss for the entire amount of liability 2 under § 1.752-2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. For disguised sale purposes, assume that G's and H's share of liability 1 is \$2,000 each in accordance with paragraph (a)(2) of this section (which determines a partner's share of a liability using the percentage under § 1.752-3(a)(3), but not exceeding the part-

ner's share of the liability under section 752 and applicable regulations). Also, in accordance with paragraph (a)(2) of this section, G's share of liability 2 is zero and H's share of liability 2 is \$3,000.

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, pursuant to § 1.707-5(a)(1) and (4), the partnership's taking property 1 subject to liability 1 is treated as a transfer of only \$4,000 of consideration to G (the amount by which liability 1 (\$6,000) exceeds G's share of liabilities 1 and 2 (\$2,000)), and the partnership's assumption of liability 2 is treated as a transfer of only \$4,000 of consideration to H (the amount by which liability 2 (\$9,000) exceeds H's share of liabilities 1 and 2 (\$5,000)). Under the rule in § 1.707-3, G is treated as having sold \$4,000 of the fair market value of property 1 in exchange for the partnership's taking property 1 subject to liability 1, and H is treated as having sold \$4,000 of the fair market value of property 2 in exchange for the partnership's assumption of liability 2.

*Example 8. Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability.* (i) The facts are the same as in *Example 7*, except that—

(A) Liability 2 is a nonrecourse liability;

(B) H transferred the proceeds of liability 2 to the partnership; and

(C) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking of property 1 subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking of property 1 subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying § 1.707-5(a)(1). See § 1.707-5(a)(4). Accordingly, the partnership's taking of property 1 subject to liability 1 is treated as a transfer of \$4,000 of consideration to G (the amount by which liability 1 (\$6,000) exceeds G's share of liability 1 (\$2,000)). Under § 1.707-5(d), the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because the amount of liability 2 that the partnership is treated as assuming is reduced by the money H transferred to the partnership (\$9,000).

*Examples 9 through 13* [Reserved]. For further guidance, see § 1.707-5(f) *Examples 9 through 13*.

(g) *Expiration date.* This section expires on October 4, 2019.

Par. 4. Section 1.707-9 is amended by adding paragraphs (a)(4) and (5) to read as follows:

*§ 1.707-9 Effective dates and transitional rules.*

(a) \* \* \*

(4) *Section 1.707-5(a)(2) and (f) Examples 2, 3, 7, and 8.* Section 1.707-5(a)(2) and (f) *Examples 2, 3, 7, and 8*, as

contained in 26 CFR part 1 revised as of April 1, 2016, apply to any transaction with respect to which any transfers occur before January 3, 2017. For any transaction with respect to which all transfers occur on or after January 3, 2017, see § 1.707-9T(a)(5).

(5) [Reserved]. For further guidance, see § 1.707-9T(a)(5).

\* \* \* \* \*

Par. 5. Section 1.707-9T is added to read as follows:

*§ 1.707-9T Effective dates and transitional rules (temporary).*

(a)(1) through (a)(4) [Reserved]. For further guidance, see § 1.707-9(a)(1) through (4).

(5) *Section 1.707-5T(a)(2) and (f) Examples 2, 3, 7, and 8.* Section 1.707-5T(a)(2) and (f) *Examples 2, 3, 7, and 8* apply to any transaction with respect to which all transfers occur on or after January 3, 2017. For any transaction with respect to which any transfers occur before January 3, 2017, see § 1.707-5(a)(2) and (f) *Examples 2, 3, 7, and 8* as contained in 26 CFR part 1, revised as of April 1, 2016.

(b) [Reserved]. For further guidance, see § 1.707-9(b).

(c) *Expiration date.* This section expires on October 4, 2019.

Par. 6. Section 1.752-2 is amended by:

1. Revising paragraph (b)(3).
2. Adding *Examples 9, 10, and 11* to paragraph (f).
3. Revising paragraph (j)(2).
4. Removing paragraph (j)(4).
5. Redesignating paragraph (l) as (l)(1) and revising the heading to paragraph (l).
6. Adding paragraphs (l)(2) and (3).

The revisions and additions read as follows:

*§ 1.752-2 Partner's share of recourse liabilities.*

\* \* \* \* \*

(b) \* \* \*

(3) [Reserved]. For further guidance, see § 1.752-2T(b)(3).

\* \* \* \* \*

(f) \* \* \*

*Example 9.* [Reserved].

*Example 10.* [Reserved]. For further guidance, see § 1.752-2T(f) *Example 10*.

*Example 11.* [Reserved]. For further guidance, see § 1.752-2T(f) *Example 11*.

\* \* \* \* \*

(j) \* \* \*

(2) [Reserved]. For further guidance, see § 1.752-2T(j)(2).

\* \* \* \* \*

(1) *Effective/applicability dates.* \* \* \*

\* \* \* \* \*

(2) [Reserved]. For further guidance, see § 1.752-2T(1)(2).

(3) [Reserved]. For further guidance, see § 1.752-2T(1)(3).

Par. 7. Section 1.752-2T is added to read as follows:

*§ 1.752-2T Partner's share of recourse liabilities (temporary).*

(a) through (b)(2) [Reserved]. For further guidance, see § 1.752-2(a) through (b)(2).

(3) *Obligations recognized—(i) In general.* The determination of the extent to which a partner or related person has an obligation to make a payment under § 1.752-2(b)(1) is based on the facts and circumstances at the time of the determination. To the extent that the obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), § 1.752-2(b) is applied as if the obligation did not exist. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including—

(A) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;

(B) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(b)(3) (taking into account § 1.704-1(b)(2)(ii)(c)); and

(C) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partner-

ship) imposed by state or local law, including the governing state or local law partnership statute.

(ii) *Special rules for bottom dollar payment obligations*—(A) *In general.* For purposes of § 1.752–2, a bottom dollar payment obligation (as defined in paragraph (b)(3)(ii)(C) of this section) is not recognized under this paragraph (b)(3).

(B) *Exception.* If a partner or related person has a payment obligation that would be recognized under this paragraph (b)(3) (initial payment obligation) but for the effect of an indemnity, reimbursement agreement, or similar arrangement, such bottom dollar payment obligation is recognized under this paragraph (b)(3) if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation.

(C) *Definition of bottom dollar payment obligation*—(1) *In general.* Except as provided in paragraph (b)(3)(ii)(C)(2) of this section, a *bottom dollar payment obligation* is a payment obligation that is the same as or similar to a payment obligation or arrangement described in this paragraph (b)(3)(ii)(C)(1).

(i) With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(ii) With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

(iii) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a

common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in paragraph (b)(3)(ii)(C)(1)(i) or (ii) of this section.

(2) *Exceptions.* A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

(3) *Benefited party defined.* For purposes of § 1.752–2, a *benefited party* is the person to whom a partner or related person has the payment obligation.

(D) *Disclosure of bottom dollar payment obligations.* A partnership must disclose to the Internal Revenue Service a bottom dollar payment obligation (including a bottom dollar payment obligation that is recognized under paragraph (b)(3)(ii)(B) of this section) with respect to a partnership liability on a completed Form 8275, Disclosure Statement, or successor form, attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified, that includes all of the following information:

(1) A caption identifying the statement as a disclosure of a bottom dollar payment obligation under section 752.

(2) An identification of the payment obligation with respect to which disclosure is made.

(3) The amount of the payment obligation.

(4) The parties to the payment obligation.

(5) A statement of whether the payment obligation is treated as recognized for purposes of this paragraph (b)(3).

(6) If the payment obligation is recognized under paragraph (b)(3)(ii)(B) of this

section, the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation and, but for an indemnity, reimbursement agreement, or similar arrangement, the partner's or related person's initial payment obligation would have been recognized under this paragraph (b)(3).

(iii) *Special rule for indemnities and reimbursement agreements.* An indemnity, reimbursement agreement, or similar arrangement will be recognized under this paragraph (b)(3) only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized under this paragraph (b)(3), or would be recognized under this paragraph (b)(3) if such person were a partner or related person.

(b)(4) through (e) [Reserved]. For further guidance, see § 1.752–2(b)(4) through (e).

(f) *Examples 1 through 9* [Reserved]. For further guidance, see § 1.752–2(f) *Examples 1 through 9*.

*Example 10. Guarantee of first and last dollars.*

(i) A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows \$1,000 from Bank. A guarantees payment of up to \$300 of the ABC liability if any amount of the full \$1,000 liability is not recovered by Bank. B guarantees payment of up to \$200, but only if the Bank otherwise recovers less than \$200. Both A and B waive their rights of contribution against each other.

(ii) Because A is obligated to pay up to \$300 if, and to the extent that, any amount of the \$1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under § 1.752–2(b)(1) is \$300.

(iii) Because B is obligated to pay up to \$200 only if and to the extent that the Bank otherwise recovers less than \$200 of the \$1,000 partnership liability, B's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under § 1.752–2(b)(1) for ABC's liability.

(iv) In sum, \$300 of ABC's liability is allocated to A under § 1.752–2(a), and the remaining \$700 liability is allocated to A, B, and C under § 1.752–3.

*Example 11. Indemnification of guarantees.* (i) The facts are the same as in *Example 10*, except that, in addition, C agrees to indemnify A up to \$100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee.

(ii) The determination of whether C's indemnity is recognized under paragraph (b)(3) of this section is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is recognized under paragraph (b)(3) of this section. The amount of C's economic risk of loss under § 1.752-2(b)(1) for its indemnity of A's guarantee is \$100.

(iii) Because C's indemnity is recognized under paragraph (b)(3) of this section, A is treated as liable for \$200 only to the extent any amount beyond \$100 of the partnership liability is not satisfied. Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and the exception in paragraph (b)(3)(ii)(B) of this section does not apply. As a result, A's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and is not recognized under paragraph (b)(3)(ii)(A) of this section. Therefore, A bears no economic risk of loss under § 1.752-2(b)(1) for ABC's liability.

(iv) Because B's obligation is not recognized under paragraph (b)(3)(ii) of this section independent of C's indemnity of B's guarantee, C's indemnity is not recognized under paragraph (b)(3)(iii) of this section. Therefore, C bears no economic risk of loss under § 1.752-2(b)(1) for its indemnity of B's guarantee.

(v) In sum, \$100 of ABC's liability is allocated to C under § 1.752-2(a) and the remaining \$900 liability is allocated to A, B, and C under § 1.752-3.

(g) through (j)(1) [Reserved]. For further guidance, see § 1.752-2(g) through (j)(1).

(2) *Arrangements tantamount to a guarantee*—(i) *In general*. Irrespective of the form of a contractual obligation, the Commissioner may treat a partner as bearing the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that—

(A) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;

(B) The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and

(C) With respect to the contractual obligations described in paragraphs (j)(2)(i)(A) and (B) of this section—

(I) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the

obligation) to include a portion of the loan in the basis of their partnership interests; or

(2) Another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation described in paragraphs (j)(2)(i)(A) and (B) of this section to be disregarded under paragraph (b)(3) of this section.

(ii) *Economic risk of loss*. For purposes of this paragraph (j)(2), partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.

(j)(3) through (l)(1) [Reserved]. For further guidance, see § 1.752-2(j)(3) through (l)(1).

(2) Paragraph (b)(3), paragraph (f) *Examples 10 and 11*, and paragraph (j)(2) of this section apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. Partnerships may apply paragraph (b)(3), paragraph (f) *Examples 10 and 11*, and paragraph (j)(2) of this section to all of their liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016. The rules applicable to liabilities incurred or assumed (or subject to a written binding contract in effect) prior to October 5, 2016 are contained in § 1.752-2 in effect prior to October 5, 2016 (see 26 CFR part 1 revised as of April 1, 2016).

(3) If a partner has a share of a recourse partnership liability under § 1.752-2(a) as a result of bearing the economic risk of loss under § 1.752-2(b) immediately prior to October 5, 2016 (Transition Partner), the partnership (Transition Partnership) may choose not to apply paragraph (b)(3), paragraph (f) *Examples 10 and 11*, and paragraph (j)(2)(i)(C)(2) of this section to

the extent the amount of the Transition Partner's share of liabilities under § 1.752-2(a) as a result of bearing the economic risk of loss under § 1.752-2(b) immediately prior to October 5, 2016 exceeds the amount of the Transition Partner's adjusted basis in its partnership interest as determined under § 1.705-1 at such time (Grandfathered Amount). A Transition Partner that is a partnership, S corporation, or a business entity disregarded as an entity separate from its owner under section 856(i) or 1361(b)(3) or §§ 301.7701-1 through 301.7701-3 of this chapter ceases to qualify as a Transition Partner if the direct or indirect ownership of that Transition Partner changes by 50 percent or more. The Transition Partnership may continue to apply the rules under § 1.752-2 in effect prior to October 5, 2016, with respect to a Transition Partner for payment obligations described in § 1.752-2(b) to the extent of the Transition Partner's adjusted Grandfathered Amount for the seven-year period beginning October 5, 2016. The termination of a Transition Partnership under section 708(b)(1)(B) and applicable regulations does not affect the Grandfathered Amount of a Transition Partner that remains a partner in the new partnership (as described in § 1.708-1(b)(4)), and the new partnership is treated as a continuation of the Transition Partnership for purposes of this paragraph (l)(3). However, a Transition Partner's Grandfathered Amount is reduced (not below zero), but never increased by—

(i) Upon the sale of any property by the Transition Partnership, an amount equal to the excess of any gain allocated for federal income tax purposes to the Transition Partner by the Transition Partnership (including amounts allocated under section 704(c) and applicable regulations) over the product of the total amount realized by the Transition Partnership from the property sale multiplied by the Transition Partner's percentage interest in the partnership; and

(ii) An amount equal to any decrease in the Transition Partner's share of liabilities to which the rules of this paragraph (l)(3) apply, other than by operation of paragraph (l)(3)(i) of this section.

(m) *Expiration date*. This section expires on October 4, 2019.

John Dalrymple,  
Deputy Commissioner  
for Services and Enforcement.

Approved: August 29, 2016.

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

(Filed by the Office of the Federal Register on October 4, 2016, 8:45 a.m., and published in the issue of the Federal Register for October 5, 2016, 81 F.R.69282)

**DEPARTMENT OF THE  
TREASURY  
Internal Revenue Service  
26 CFR Part 1**

**T.D. 9800**

**Covered Asset Acquisitions**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary Income Tax Regulations under section 901(m) of the Internal Revenue Code (Code) with respect to transactions that generally are treated as asset acquisitions for U.S. income tax purposes and either are treated as stock acquisitions or are disregarded for foreign income tax purposes. These regulations are necessary to provide guidance on applying section 901(m). The text of the temporary regulations also serves in part as the text of the proposed regulations under section 901(m) (REG-129128-14) published in the Proposed Rules section of this issue of the **Bulletin**.

DATES: *Effective date:* These regulations are effective on December 7, 2016.

*Applicability dates:* For dates of applicability, see §§ 1.901(m)-1T(b), 1.901(m)-2T(f), 1.901(m)-4T(g), 1.901(m)-5T(i), and 1.901(m)-6T(d).

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry, (202) 317-6936 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

**I. Section 901(m)**

Section 212 of the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010 (Public Law 111-226), added section 901(m) to the Code. Section 901(m)(1) provides that, in the case of a covered asset acquisition (CAA), the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to relevant foreign assets (RFAs) will not be taken into account in determining the foreign tax credit allowed under section 901(a), and in the case of foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), will not be taken into account for purposes of section 902 or 960. Instead, the disqualified portion of any foreign income tax (the disqualified tax amount) is permitted as a deduction. See section 901(m)(6).

Under section 901(m)(2), a CAA is (i) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies; (ii) any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as the acquisition of stock of a corporation (or is disregarded) for purposes of a foreign income tax; (iii) any acquisition of an interest in a partnership that has an election in effect under section 754; and (iv) to the extent provided by the Secretary, any other similar transaction.

Section 901(m)(3)(A) provides that the term “disqualified portion” means, with respect to any CAA, for any taxable year, the ratio (expressed as a percentage) of (i) the aggregate basis differences (but not below zero) allocable to such taxable year with respect to all RFAs; divided by (ii) the income on which the foreign income tax referenced in section 901(m)(1) is determined. If the taxpayer fails to substantiate the income on which the foreign income tax is determined to the satisfaction of the Secretary, such income will be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to the taxpayer’s income in the relevant jurisdiction.

Section 901(m)(3)(B)(i) provides the general rule that the basis difference with respect to any RFA will be allocated to

taxable years using the applicable cost recovery method for U.S. income tax purposes. Section 901(m)(3)(B)(ii) provides that, except as otherwise provided by the Secretary, if there is a disposition of an RFA, the basis difference allocated to the taxable year of the disposition will be the excess of the basis difference of such asset over the aggregate basis difference of such asset that has been allocated to all prior taxable years. The statute further provides that no basis difference with respect to such asset will be allocated to any taxable year thereafter.

Section 901(m)(3)(C)(i) provides that basis difference means, with respect to any RFA, the excess of (i) the adjusted basis of such asset immediately after the CAA, over (ii) the adjusted basis of such asset immediately before the CAA. If the adjusted basis of an RFA immediately before the CAA exceeds the adjusted basis of the RFA immediately after the CAA (that is, where the adjusted basis of an asset with a built-in loss is reduced in a CAA), such excess is taken into account as a basis difference of a negative amount. See section 901(m)(3)(C)(ii).

Section 901(m)(4) provides that an RFA means, with respect to a CAA, an asset (including goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the foreign income tax referenced in section 901(m)(1).

Section 901(m)(7) provides that the Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 901(m).

**II. Notices 2014-44 and 2014-45**

The Department of the Treasury (Treasury Department) and the IRS issued Notice 2014-44 (2014-32 I.R.B. 270 (July 21, 2014)) and Notice 2014-45 (2014-34 I.R.B. 388 (July 29, 2014)), announcing the intent to issue regulations addressing the application of section 901(m) to dispositions of RFAs following CAAs and to CAAs described in section 901(m)(2)(C) (regarding section 754 elections).

The notices were issued in response to certain taxpayers engaging in transactions shortly after a CAA with the intention of invoking the application of the statutory

disposition rule under section 901(m)(3)(B)(ii) to avoid the purposes of section 901(m). To address these transactions, Notice 2014-44 described the definition of disposition that would be set forth in future regulations, as well as the rules for determining the portion of basis difference that would be taken into account upon a disposition of an RFA (the disposition amount). In addition, Notice 2014-44 described the computation of basis difference and disposition amount with respect to an RFA that is subject to a section 743(b) CAA. Notice 2014-44 also announced that future regulations would provide successor rules for the continued application of section 901(m) after a subsequent transfer of an RFA with remaining basis difference. Notice 2014-44 further provided that future regulations would provide that, if an asset is an RFA with respect to two section 743(b) CAAs involving the same partnership interest, the RFA will be treated as having no remaining basis difference with respect to the first section 743(b) CAA if the basis difference with respect to the second section 743(b) CAA is determined independently from the first section 743(b) CAA. In this regard, see generally § 1.743-1(f) and proposed § 1.743-1(f)(2).

Notice 2014-44 provided that the future regulations described therein would apply (i) concerning dispositions, to dispositions occurring on or after July 21, 2014 (the date Notice 2014-44 was issued), (ii) concerning section 743(b) CAAs, to section 743(b) CAAs occurring on or after July 21, 2014, unless a taxpayer consistently applied those provisions to all section 743(b) CAAs occurring on or after January 1, 2011, and (iii) concerning successor rules, to remaining basis difference with respect to an RFA as of July 21, 2014, and any basis difference with respect to an RFA that arises in a CAA occurring on or after July 21, 2014. Notice 2014-45 provided that the future regulations described in Notice 2014-44 also would apply to determine the tax consequences under section 901(m) of an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014 (the date Notice 2014-45 was issued), including whether a disposition results from the election for purposes of section 901(m) and the treatment of any

remaining basis difference that results from such an election.

### III. Proposed Regulations Under Section 901(m)

Proposed regulations under section 901(m) are being issued at the same time as these temporary regulations. In addition to cross-referencing these temporary regulations, the proposed regulations provide guidance under section 901(m) concerning issues not addressed in the temporary regulations. Consulting the preamble to the proposed regulations is recommended for a better understanding of how these temporary regulations are intended to work.

#### Explanation of Provisions

##### I. Overview

Section 1.901(m)-1T provides definitions that apply for purposes of the temporary regulations. Section 1.901(m)-2T identifies the transactions that are CAAs and the assets that are RFAs with respect to a CAA. Section 1.901(m)-4T provides the general rule for determining basis difference with respect to an RFA under section 901(m)(3)(C), as well as a special rule for determining basis difference with respect to an RFA that arises as a result of an acquisition of an interest in a partnership that has made a section 754 election (section 743(b) CAA). Section 1.901(m)-5T provides rules for taking into account basis difference under the applicable cost recovery method or as a result of a disposition of an RFA. Section 1.901(m)-6T provides successor rules for applying section 901(m) to subsequent transfers of RFAs that have basis difference that has not yet been fully taken into account.

##### II. Effective/Applicability Dates

The applicability dates of the temporary regulations relate back to the issuance of Notices 2014-44 and 2014-45. Accordingly, the temporary regulations apply to CAAs occurring on or after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014 (re-

ferred to as the general applicability date). The temporary regulations also apply to CAAs occurring on or after January 1, 2011, and before the general applicability date (the transition period), but only if the basis difference within the meaning of section 901(m)(3)(C)(i) (statutory basis difference) in one or more RFAs with respect to such a CAA had not been fully taken into account under section 901(m)(3)(B) either as of July 21, 2014, or, in the case of an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, prior to the transactions that are deemed to occur under § 301.7701-3(g) as a result of the change in classification.

Taxpayers also may choose to consistently apply § 1.901(m)-4T(d)(1) (regarding the determination of basis difference in an RFA with respect to a section 743(b) CAA) to all section 743(b) CAAs occurring on or after January 1, 2011.

##### III. CAAs and RFAs

Section 1.901(m)-2T(b) identifies the transactions that are CAAs under section 901(m)(2)(A) through (C). Section 1.901(m)-2T(c) provides that, with respect to a foreign income tax and a CAA, an RFA is any asset (including goodwill, going concern value, or other intangible) subject to the CAA that is relevant in determining foreign income for purposes of the foreign income tax. An asset is subject to a CAA, if, for example (i) in the case of a qualified stock purchase of a target corporation (as defined in section 338(d)(3)) to which section 338(a) applies, “new” target is treated as purchasing the asset from “old” target; (ii) in the case of a taxable acquisition of a disregarded entity that is treated as an acquisition of stock for foreign income tax purposes, the asset is owned by the disregarded entity at that time of the purchase and therefore the buyer is treated as purchasing the asset from the seller; and (iii) in the case of a section 743(b) CAA, the asset is attributable to the partnership interest transferred in the section 743(b) CAA.

Section 1.901(m)-2T(d) provides that the statutory definitions under section 901(m)(2) and 901(m)(4) apply to determine whether a transaction that occurred during the transition period is a CAA and

which assets are RFAs with respect to those CAAs, respectively.

#### IV. Determining Basis Difference with Respect to an RFA

A basis difference is computed separately with respect to each foreign income tax for which an asset is an RFA. Consistent with section 901(m)(3)(C), § 1.901(m)-4T(b) provides the general rule that basis difference with respect to an RFA is the U.S. basis in the RFA immediately after the CAA, less the U.S. basis in the RFA immediately before the CAA. If, however, an asset is an RFA with respect to a section 743(b) CAA, § 1.901(m)-4T(d) provides that basis difference with respect to the RFA is the resulting basis adjustment under section 743(b) that is allocated to the RFA under section 755.

Section 1.901(m)-2T(e) “resets” the basis difference in an RFA with respect to a CAA that occurred during the transition period by defining basis difference in the RFA as the portion of statutory basis difference that had not been taken into account under section 901(m)(3)(B) either as of July 21, 2014, or, in the case of an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, prior to the transactions that are deemed to occur under § 301.7701-3(g) as a result of the change in classification. This is the basis difference in the RFA for the period to which the temporary regulations apply.

#### V. Basis Difference Taken into Account

Section 1.901(m)-5T provides rules for determining the amount of basis difference with respect to an RFA that is taken into account in a given U.S. taxable year (allocated basis difference). The amount of basis difference taken into account in a U.S. taxable year is used to compute a disqualified tax amount for the U.S. taxable year. Basis difference is taken into account in two ways: under an applicable cost recovery method or as a result of a disposition of the RFA. If an asset is an RFA with respect to more than one foreign income tax, basis difference with respect to each foreign income tax is separately taken into account under § 1.901(m)-5T.

#### A. Determining cost recovery amounts

Consistent with section 901(m)(3)(B)(i), § 1.901(m)-5T(b)(2) provides that a cost recovery amount for an RFA is determined by applying an applicable cost recovery method to the basis difference rather than to the U.S. basis of the RFA.

#### B. Determining disposition amounts

##### 1. Overview

Section 901(m)(3)(B)(ii) provides that, except as otherwise provided by the Secretary, if there is a disposition of an RFA, the basis difference allocated to the U.S. taxable year of the disposition shall be the excess of the basis difference of such RFA over the total amount of such basis difference that has been allocated to all prior U.S. taxable years (unallocated basis difference). This result is appropriate when all the gain or loss from the disposition is recognized for both U.S. and foreign income tax purposes. In other cases, however, a disposition may not be the appropriate time for all of the unallocated basis difference to be taken into account. For example, it may not be appropriate for all of the unallocated basis difference to be taken into account upon a disposition that is fully taxable for U.S. income tax purposes but not for foreign income tax purposes. Accordingly, under the specific authority granted to the Secretary with respect to dispositions, these temporary regulations provide rules to determine when less than all of the unallocated basis difference is taken into account as a result of a disposition.

##### 2. Definition of disposition

Section 1.901(m)-1T(a)(10) defines a disposition for purposes of section 901(m) as an event that results in gain or loss being recognized with respect to an RFA for purposes of U.S. income tax or foreign income tax, or both. Thus, the definition excludes certain transfers that might otherwise be considered dispositions under the ordinary meaning of that term. For example, an entity classification election by an RFA owner that results in a tax-free deemed liquidation for U.S. income tax purposes but that is disregarded for for-

ign income tax purposes does not result in a disposition of the RFAs under section 901(m), because no gain or loss is recognized for U.S. or foreign income tax purposes with respect to the distribution of the RFAs in the deemed liquidation. This is the case even though the deemed liquidation might otherwise be considered a “disposition” of assets under other provisions of the Code.

##### 3. Determining a disposition amount

Section 1.901(m)-5T(c)(2) provides rules for determining a disposition amount. If a disposition of an RFA is fully taxable for U.S. and foreign income tax purposes, the disposition amount will be any remaining unallocated basis difference with respect to that RFA. This is because there generally will no longer be a disparity in the U.S. basis and the foreign basis of the RFA.

If a disposition is not fully taxable for both U.S. and foreign income tax purposes, generally there will continue to be a disparity in the U.S. basis and the foreign basis following the disposition, and it will be appropriate for the RFA to continue to have unallocated basis difference. To the extent that the disparity in the U.S. basis and the foreign basis is reduced as a result of the disposition, however, a portion of the unallocated basis difference (or, in certain cases, all of the unallocated basis difference) should be taken into account. Whether the disposition reduces the basis disparity will depend on whether the basis difference is positive or negative and the jurisdiction in which gain or loss is recognized.

If an RFA has a positive basis difference, a reduction in basis disparity generally will occur upon a disposition of the RFA if (i) a foreign disposition gain is recognized, which generally results in an increase in the foreign basis of the RFA, or (ii) a U.S. disposition loss is recognized, which generally results in a decrease in the U.S. basis of the RFA. Accordingly, if an RFA has a positive basis difference, the disposition amount equals the lesser of (i) any foreign disposition gain plus any U.S. disposition loss (for this purpose, expressed as a positive amount), or (ii) unallocated basis difference. See § 1.901(m)-5T(c)(2)(ii)(A).

If an RFA has a negative basis difference, a reduction in basis disparity generally will occur upon a disposition of the RFA if (i) a foreign disposition loss is recognized, which generally results in a decrease in the foreign basis of the RFA, or (ii) a U.S. disposition gain is recognized, which generally results in an increase in the U.S. basis of the RFA. Accordingly, if an RFA has a negative basis difference, the disposition amount equals the greater of (i) any U.S. disposition gain (for this purpose, expressed as a negative amount) plus any foreign disposition loss, or (ii) unallocated basis difference. See § 1.901(m)-5T(c)(2)(ii)(B).

For the avoidance of doubt, the determination of whether there is a disposition for U.S. income tax purposes, and the amount of U.S. disposition gain or U.S. disposition loss, is made without regard to whether gain or loss is deferred or disallowed or otherwise not taken into account currently (for example, see section 267, which defers or disallows certain recognized losses, and § 1.1502-13, which provides rules for taking into account items of income, gain, deduction, and loss of members of a U.S. consolidated group from intercompany transactions). This principle also applies if foreign law has an equivalent concept whereby gain or loss that is realized and recognized is deferred or disallowed.

If an asset is an RFA by reason of a section 743(b) CAA and subsequently there is a disposition of the RFA, then for purposes of determining the disposition amount, foreign disposition gain or foreign disposition loss means the amount of gain or loss recognized for purposes of a foreign income tax on the disposition of the RFA that is allocable to the partnership interest that was transferred in the section 743(b) CAA. See § 1.901(m)-5T(c)(2)(iii). In addition, U.S. disposition gain or U.S. disposition loss means the amount of gain or loss recognized for U.S. income tax purposes on the disposition of the RFA that is allocable to the partnership interest that was transferred in the section 743(b) CAA, taking into account the basis adjustment under section 743(b) that was allocated to the RFA under section 755 in the section 743(b) CAA. See *id.*

## VI. Successor Rules for Unallocated Basis Difference

### A. General rules

Section 1.901(m)-6T(b) provides that section 901(m) continues to apply to any unallocated basis difference with respect to an RFA after there is a transfer of the RFA for U.S. income tax purposes (successor transaction), regardless of whether the transfer is a disposition, a CAA, or a non-taxable transaction. A successor transaction does not occur if, as a result of the transfer of an RFA, the entire unallocated basis difference is taken into account because, for example, the transfer results in all realized gain or loss in the RFA being recognized for U.S. and foreign income tax purposes.

Notice 2014-44 stated that the Treasury Department and the IRS are continuing to study whether and to what extent section 901(m) should apply to an asset received in exchange for an RFA in a transaction in which the U.S. basis of the asset is determined by reference to the U.S. basis of the transferred RFA. The Treasury Department and the IRS have determined that an asset should not become an RFA solely because the U.S. basis of that asset is determined by reference to the U.S. basis of an RFA for which the asset is exchanged in a successor transaction. Accordingly, for example, if, in a successor transaction, an RFA owner transfers an RFA to a corporation in a transfer to which section 351 applies, the stock of the transferee corporation received is not an RFA even though the U.S. basis of the stock is determined under section 358 by reference to the U.S. basis of the RFA transferred.

### B. Successor transactions that are CAAs

An asset may be an RFA with respect to multiple CAAs if a successor transaction is also a CAA (subsequent CAA). In this case, the subsequent CAA may give rise to additional basis difference. Section 1.901(m)-6T(b)(4)(i) provides generally that the unallocated basis difference with respect to a CAA that occurred prior to the subsequent CAA (referred to in the regulations as a “prior CAA”) will continue to

be taken into account under section 901(m) after the subsequent CAA.

Section 1.901(m)-6T(b)(4)(iii) provides an exception to the general rule if an RFA is subject to two section 743(b) CAAs (referred to in the regulations as a “prior section 743(b) CAA” and a “subsequent section 743(b) CAA”). In this case, to the extent the same partnership interest is transferred in the section 743(b) CAAs, the RFA will be treated as having no unallocated basis difference with respect to the prior section 743(b) CAA if basis difference for the subsequent section 743(b) CAA is determined independently from the prior section 743(b) CAA. In this regard, see generally § 1.743-1(f) and proposed § 1.743-1(f)(2). If the subsequent section 743(b) CAA results from the acquisition of only a portion of the partnership interest acquired in the prior section 743(b) CAA, the transferor must equitably apportion the unallocated basis difference attributable to the prior section 743(b) CAA between the portion of the interest retained and the portion of the interest transferred. With respect to the portion transferred, the RFA will be treated as having no unallocated basis difference attributable to the prior section 743(b) CAA.

## VII. Definition of Foreign Income Tax

For purposes of section 901(m), the temporary regulations define “foreign income tax” as any income, war profits, or excess profits tax for which a credit is allowable under section 901 or 903, other than any withholding tax determined on a gross basis as described in section 901(k)(1)(B). The Treasury Department and the IRS have determined that a withholding tax should not be subject to disallowance under section 901(m) because a withholding tax is a gross basis tax that is generally unaffected by changes in asset basis.

### Effect on Other Documents

The following publications are obsolete as of December 7, 2016:

Notice 2014-44 (2014-32 I.R.B. 270) and Notice 2014-45 (2014-34 I.R.B. 388).

## Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble of the cross-referenced notice of proposed rule-making published in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

## Drafting Information

The principal author of these regulations is Jeffrey L. Parry of the Office of Associate Chief Counsel (International). 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 is amended by adding entries in numerical order to read as follows:

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

Sections 1.901(m)-1T through -8T also issued under 26 U.S.C. 901(m)(7).

Section 1.901(m)-5T also issued under 26 U.S.C. 901(m)(3)(B)(ii). \* \* \*

Par. 2. Section 1.901(m)-1T is added to read as follows:

#### § 1.901(m)-1T Definitions (temporary).

(a) *Definitions*. For purposes of section 901(m), this section, and §§ 1.901(m)-2T through 1.901(m)-8T, the following definitions apply:

(1)–(5) [Reserved].

(6) The term *basis difference* has the meaning provided in § 1.901(m)-4T.

(7) The term *cost recovery amount* has the meaning provided in § 1.901(m)-5T(b)(2).

(8) The term *covered asset acquisition* (or *CAA*) has the meaning provided in § 1.901(m)-2T.

(9) [Reserved].

(10) The term *disposition* means an event (for example, a sale, abandonment, or mark-to-market event) that results in gain or loss being recognized with respect to an RFA for purposes of U.S. income tax or a foreign income tax, or both.

(11) The term *disposition amount* has the meaning provided in § 1.901(m)-5T(c)(2).

(12) [Reserved].

(13) The term *disregarded entity* means an entity that is disregarded as an entity separate from its owner, as described in § 301.7701-2(c)(2)(i) of this chapter.

(14) The term *fiscally transparent entity* means an entity, including a disregarded entity, that is fiscally transparent under the principles of § 1.894-1(d)(3) for purposes of U.S. income tax or a foreign income tax (or both).

(15)–(17) [Reserved].

(18) The term *foreign disposition gain* means, with respect to a foreign income tax, the amount of gain recognized on a disposition of an RFA in determining foreign income, regardless of whether the gain is deferred or otherwise not taken into account currently. Notwithstanding the foregoing, if after a section 743(b) CAA there is a disposition of an asset that is an RFA with respect to that section 743(b) CAA, foreign disposition gain has the meaning provided in § 1.901(m)-5T(c)(2)(iii).

(19) The term *foreign disposition loss* means, with respect to a foreign income tax, the amount of loss recognized on a disposition of an RFA in determining foreign income, regardless of whether the loss is deferred or disallowed or otherwise not taken into account currently. Notwithstanding the foregoing, if after a section 743(b) CAA there is a disposition of an asset that is an RFA with respect to that section 743(b) CAA, foreign disposition loss has the meaning provided in § 1.901(m)-5T(c)(2)(iii).

(20) The term *foreign income* means, with respect to a foreign income tax, the

taxable income (or loss) reflected on a foreign tax return (as properly amended or adjusted), even if the taxable income (or loss) is reported by an entity that is a fiscally transparent entity for purposes of the foreign income tax. If, however, foreign law imposes tax on the combined income (within the meaning of § 1.901-2(f)(3)(ii)) of two or more foreign payors, foreign income means the combined taxable income (or loss) of such foreign payors, regardless of whether such income (or loss) is reflected on a single foreign tax return.

(21) The term *foreign income tax* means an income, war profits, or excess profits tax for which a credit is allowable under section 901 or 903, except that it does not include any withholding tax determined on a gross basis as described in section 901(k)(1)(B).

(22)–(25) [Reserved].

(26) The term *prior CAA* has the meaning provided in § 1.901(m)-6T(b)(2).

(27) The term *prior section 743(b) CAA* has the meaning provided in § 1.901(m)-6T(b)(4)(iii).

(28) The term *relevant foreign asset* (or *RFA*) has the meaning provided in § 1.901(m)-2T.

(29)–(32) [Reserved].

(33) The term *section 338 CAA* has the meaning provided in § 1.901(m)-2T(b)(1).

(34) The term *section 743(b) CAA* has the meaning provided in § 1.901(m)-2T(b)(3).

(35) [Reserved].

(36) The term *subsequent CAA* has the meaning provided in § 1.901(m)-6T(b)(4)(i).

(37) The term *subsequent section 743(b) CAA* has the meaning provided in § 1.901(m)-6T(b)(4)(iii).

(38) The term *successor transaction* has the meaning provided in § 1.901(m)-6T(b)(2).

(39) [Reserved].

(40) The term *unallocated basis difference* means, with respect to an RFA and a foreign income tax, the basis difference reduced by the sum of the cost recovery amounts and the disposition amounts that have been computed under § 1.901(m)-5T.

(41) The term *U.S. basis* means the adjusted basis of an asset determined for U.S. income tax purposes.

(42) [Reserved].

(43) The term *U.S. disposition gain* means the amount of gain recognized for U.S. income tax purposes on a disposition of an RFA, regardless of whether the gain is deferred or otherwise not taken into account currently. Notwithstanding the foregoing, if after a section 743(b) CAA there is a disposition of an asset that is an RFA with respect to that section 743(b) CAA, U.S. disposition gain has the meaning provided in § 1.901(m)-5T(c)(2)(iii).

(44) The term *U.S. disposition loss* means the amount of loss recognized for U.S. income tax purposes on a disposition of an RFA, regardless of whether the loss is deferred or disallowed or otherwise not taken into account currently. Notwithstanding the foregoing, if after a section 743(b) CAA there is a disposition of an asset that is an RFA with respect to that section 743(b) CAA, U.S. disposition loss has the meaning provided in § 1.901(m)-5T(c)(2)(iii).

(45) The term *U.S. taxable year* means a taxable year as defined in section 7701(a)(23).

(b) *Effective/applicability date.* (1) [Reserved].

(2) Paragraphs (a)(6), (7), (8), (10), (11), (13), (14), (18), (19), (20), (21), (26), (27), (28), (33), (34), (36), (37), (38), (40), (41), (43), (44), and (45) of this section apply to CAAs occurring on or after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014. Paragraphs (a)(6), (7), (8), (10), (11), (13), (14), (18), (19), (20), (21), (26), (27), (28), (33), (34), (36), (37), (38), (40), (41), (43), (44), and (45) of this section also apply to CAAs occurring on or after January 1, 2011, and before July 21, 2014, other than CAAs occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, but only if the basis difference (within the meaning of section 901(m)(3)(C)(i)) in one or more RFAs with respect to the CAA had not been fully taken

into account under section 901(m)(3)(B) either as of July 21, 2014, or, in the case of an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, prior to the transactions that are deemed to occur under § 301.7701-3(g) as a result of the change in classification.

(3) [Reserved].

(c) *Expiration date.* The applicability of this section expires on December 6, 2019.

Par. 3. Section 1.901(m)-2T is added to read as follows:

*§ 1.901(m)-2T Covered asset acquisitions and relevant foreign assets (temporary).*

(a) *In general.* Paragraph (b) of this section sets forth the transactions that are covered asset acquisitions (or CAAs). Paragraph (c) of this section provides rules for identifying assets that are relevant foreign assets (or RFAs) with respect to a CAA. Paragraph (d) of this section provides special rules for identifying CAAs and RFAs with respect to transactions to which paragraphs (b) and (c) of this section do not apply. Paragraph (e) of this section provides examples illustrating the rules of this section. Paragraph (f) of this section provides the effective/applicability date, and paragraph (g) of this section provides the expiration date.

(b) *Covered asset acquisitions.* Except as provided in paragraph (d) of this section, the transactions set forth in this paragraph (b) are CAAs.

(1) A qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (section 338 CAA);

(2) Any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as an acquisition of stock of a corporation (or the transaction is disregarded) for foreign income tax purposes;

(3) Any acquisition of an interest in a partnership that has an election in effect under section 754 (section 743(b) CAA);

(4)-(6) [Reserved].

(c) *Relevant foreign asset*—(1) *In general.* Except as provided in paragraph (d) of this section, an RFA means, with respect to a foreign income tax and a CAA, any asset (including goodwill, going con-

cern value, or other intangible) subject to the CAA that is relevant in determining foreign income for purposes of the foreign income tax.

(2) *RFA status with respect to a foreign income tax* [Reserved].

(3) *Subsequent RFA status with respect to another foreign income tax* [Reserved].

(d) *Identifying covered asset acquisitions and relevant foreign assets to which paragraphs (b) and (c) of this section do not apply.* For transactions occurring on or after January 1, 2011, and before July 21, 2014, other than transactions occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, the transactions set forth under section 901(m)(2) are CAAs and the assets that are relevant foreign assets with respect to the CAA under section 901(m)(4) are RFAs.

(e) *Examples.* [Reserved].

(f) *Effective/applicability date*—(1) Paragraphs (a), (b)(1) through (3), and (c)(1) of this section apply to transactions occurring on or after July 21, 2014, and to transactions occurring before that date resulting from an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014. Paragraph (d) of this section applies to transactions occurring on or after January 1, 2011, and before July 21, 2014, other than transactions occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014.

(2)-(3) [Reserved].

(g) *Expiration date.* The applicability of this section expires on December 6, 2019.

Par. 4. Section 1.901(m)-3T is added and reserved to read as follows:

*§ 1.901(m)-3T Disqualified tax amount and aggregate basis difference carryover (temporary).* [Reserved].

Par. 5. Section 1.901(m)-4T is added to read as follows:

§ 1.901(m)-4T Determination of basis difference (temporary).

(a) *In general.* This section provides rules for determining for each RFA the basis difference that arises as a result of a CAA. A basis difference is computed separately with respect to each foreign income tax for which an asset subject to a CAA is an RFA. Paragraph (b) of this section provides the general rule for determining basis difference that references only U.S. basis in the RFA. Paragraph (c) of this section provides for an election to determine basis difference by reference to foreign basis and sets forth the procedures for making the election. Paragraph (d) of this section provides special rules for determining basis difference in the case of a section 743(b) CAA. Paragraph (e) of this section provides a special rule for determining basis difference in an RFA with respect to a CAA to which paragraphs (b) through (d) of this section do not apply. Paragraph (f) of this section provides examples illustrating the rules of this section. Paragraph (g) of this section provides the effective/applicability date, and paragraph (h) of this section provides the expiration date.

(b) *General rule.* Except as otherwise provided in paragraphs (c), (d), and (e) of this section, basis difference is the U.S. basis in the RFA immediately after the CAA, less the U.S. basis in the RFA immediately before the CAA. Basis difference is an attribute that attaches to an RFA.

(c) *Foreign basis election.* [Reserved].

(d) *Determination of basis difference in a section 743(b) CAA—(1) In general.* Except as provided in paragraphs (d)(2) and (e) of this section, if there is a section 743(b) CAA, basis difference is the resulting basis adjustment under section 743(b) that is allocated to the RFA under section 755.

(2) *Foreign basis election.* [Reserved].

(e) *Determination of basis difference in an RFA with respect to a CAA with respect to which paragraphs (b), (c), and (d) of this section do not apply.* For CAAs occurring on or after January 1, 2011, and before July 21, 2014, other than CAAs occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 of this chapter that is

filed on or after July 29, 2014, and that is effective on or before July 21, 2014, basis difference in an RFA with respect to the CAA is the amount of any basis difference (within the meaning of section 901(m)(3)(C)(i)) that had not been taken into account under section 901(m)(3)(B) either as of July 21, 2014, or, in the case of an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, prior to the transactions that are deemed to occur under § 301.7701-3(g) as a result of the change in classification.

(f) *Examples.* [Reserved].

(g) *Effective/applicability date.* (1) Paragraphs (a), (b), and (d)(1) of this section apply to CAAs occurring on or after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014. Paragraph (e) of this section applies to CAAs occurring on or after January 1, 2011, and before July 21, 2014, other than CAAs occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014. Taxpayers may, however, consistently apply paragraph (d)(1) of this section to all section 743(b) CAAs occurring on or after January 1, 2011. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

(2)-(3) [Reserved].

(h) *Expiration date.* The applicability of this section expires on December 6, 2019.

Par. 6. Section 1.901(m)-5T is added to read as follows:

§ 1.901(m)-5T Basis difference taken into account (temporary).

(a) *In general.* [Reserved].

(b) *Basis difference taken into account under applicable cost recovery method—(1) In general.* [Reserved].

(2) *Determining a cost recovery amount—(i) General rule.* A cost recovery amount for an RFA is determined by applying the applicable cost recovery

method to the basis difference rather than to the U.S. basis.

(ii) *U.S. basis subject to multiple cost recovery methods.* [Reserved].

(3) *Applicable cost recovery method.* [Reserved].

(c) *Basis difference taken into account as a result of a disposition—(1) In general.* [Reserved].

(2) *Determining a disposition amount—(i) Disposition is fully taxable for purposes of both U.S. income tax and the foreign income tax.* If a disposition of an RFA is fully taxable (that is, results in all gain or loss, if any, being recognized with respect to the RFA) for purposes of both U.S. income tax and the foreign income tax, the disposition amount is equal to the unallocated basis difference with respect to the RFA.

(ii) *Disposition is not fully taxable for purposes of U.S. income tax or the foreign income tax (or both).* If the disposition of an RFA is not fully taxable for purposes of both U.S. income tax and the foreign income tax, the disposition amount is determined under this paragraph (c)(2)(ii). See § 1.901(m)-6T for rules regarding the continued application of section 901(m) if the RFA has any unallocated basis difference after determining the disposition amount under paragraph (c)(2)(ii)(A) or (B) of this section, as applicable.

(A) *Positive basis difference.* If the disposition of an RFA is not fully taxable for purposes of both U.S. income tax and the foreign income tax, and the RFA has a positive basis difference, the disposition amount equals the lesser of:

(1) Any foreign disposition gain plus any U.S. disposition loss (for this purpose, expressed as a positive amount), or

(2) Unallocated basis difference with respect to the RFA.

(B) *Negative basis difference.* If the disposition of an RFA is not fully taxable for purposes of both U.S. income tax and the foreign income tax, and the RFA has a negative basis difference, the disposition amount equals the greater of:

(1) Any U.S. disposition gain (for this purpose, expressed as a negative amount) plus any foreign disposition loss, or

(2) Unallocated basis difference with respect to the RFA.

(iii) *Disposition of an RFA after a section 743(b) CAA.* If an RFA was subject to

a section 743(b) CAA and subsequently there is a disposition of the RFA, then, for purposes of determining the disposition amount, foreign disposition gain or foreign disposition loss are specially defined to mean the amount of gain or loss recognized for purposes of the foreign income tax on the disposition of the RFA that is allocable to the partnership interest that was transferred in the section 743(b) CAA. In addition, U.S. disposition gain or U.S. disposition loss are specially defined to mean the amount of gain or loss recognized for U.S. income tax purposes on the disposition of the RFA that is allocable to the partnership interest that was transferred in the section 743(b) CAA, taking into account the basis adjustment under section 743(b) that was allocated to the RFA under section 755.

(d) *General rules for allocating and assigning a cost recovery amount or a disposition amount when the RFA owner (U.S.) is a fiscally transparent entity.* [Reserved].

(e) *Special rules for certain section 743(b) CAAs.* [Reserved].

(f) *Mid-year transactions.* [Reserved].

(g) *Reverse hybrids.* [Reserved].

(h) *Examples.* [Reserved].

(i) *Effective/applicability date.* (1) [Reserved].

(2) Paragraphs (b)(2)(i) and (c)(2) of this section apply to CAAs occurring on or after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014. Paragraphs (b)(2)(i) and (c)(2) of this section also apply to CAAs occurring on or after January 1, 2011, and before July 21, 2014, other than CAAs occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, but only with respect to basis difference determined under § 1.901(m)-4T(e) with respect to the CAA.

(3) [Reserved].

(j) *Expiration date.* The applicability of this section expires on December 6, 2019.

Par. 7. Section 1.901(m)-6T is added to read as follows:

*§ 1.901(m)-6T Successor rules (temporary).*

(a) *In general.* This section provides successor rules applicable to section 901(m). Paragraph (b) of this section provides rules for the continued application of section 901(m) after an RFA that has unallocated basis difference has been transferred, including special rules applicable to successor transactions that are also CAAs or that involve partnerships. Paragraph (c) of this section provides rules for determining when an aggregate basis difference carryover of a section 901(m) payor either becomes an aggregate basis difference carryover of the section 901(m) payor with respect to another foreign payor or is transferred to another section 901(m) payor. Paragraph (d) of this section provides the effective/applicability date, and paragraph (e) of this section provides the expiration date.

(b) *Successor rules for unallocated basis difference—(1) In general.* Except as provided in paragraph (b)(4) of this section, section 901(m) continues to apply after a successor transaction to any unallocated basis difference attached to a transferred RFA until the entire basis difference has been taken into account as a cost recovery amount or a disposition amount (or both) under § 1.901(m)-5T.

(2) *Definition of a successor transaction.* A successor transaction occurs with respect to an RFA if, after a CAA (prior CAA), there is a transfer of the RFA for U.S. income tax purposes and the RFA has unallocated basis difference with respect to the prior CAA, determined immediately after the transfer. A successor transaction may occur regardless of whether the transfer of the RFA is a disposition, a CAA, or a non-taxable transaction for purposes of U.S. income tax. If the RFA was subject to multiple prior CAAs, a separate determination must be made with respect to each prior CAA as to whether the transfer is a successor transaction.

(3) *Special considerations.* [Reserved].

(4) *Successor transaction is a CAA—(i) In general.* An asset may be an RFA with respect to multiple CAAs if a successor transaction is also a CAA (subsequent CAA). Except as otherwise provided in this paragraph (b)(4), if there is a

subsequent CAA, unallocated basis difference with respect to any prior CAAs will continue to be taken into account under section 901(m) after the subsequent CAA. Furthermore, the subsequent CAA may give rise to additional basis difference subject to section 901(m).

(ii) *Foreign basis election.* [Reserved].

(iii) *Multiple section 743(b) CAAs.* If an RFA is subject to two section 743(b) CAAs (prior section 743(b) CAA and subsequent section 743(b) CAA) and the same partnership interest is acquired in both the CAAs, the RFA will be treated as having no unallocated basis difference with respect to the prior section 743(b) CAA if the basis difference for the section 743(b) CAA is determined independently from the prior section 743(b) CAA. In this regard, see generally § 1.743-1(f). If the subsequent section 743(b) CAA results from the acquisition of only a portion of the partnership interest acquired in the prior section 743(b) CAA, then the transferor will be required to equitably apportion the unallocated basis difference attributable to the prior section 743(b) CAA between the portion retained by the transferor and the portion transferred. In this case, with respect to the portion transferred, the RFAs will be treated as having no unallocated basis difference with respect to the prior section 743(b) CAA if basis difference for the subsequent section 743(b) CAA is determined independently from the prior section 743(b) CAA.

(5) *Example.* The following example illustrates the rules of paragraph (b) of this section.

*Example.* (i) *Facts.* USP, a domestic corporation, wholly owns CFC, a foreign corporation organized in Country A and treated as a corporation for both U.S. and Country A tax purposes. FT is an unrelated foreign corporation organized in Country A and treated as a corporation for both U.S. and Country A tax purposes. FT owns one asset, a parcel of land (Asset). Country A imposes a single tax that is a foreign income tax. On January 1, Year 1, CFC acquires all of the stock of FT in exchange for 300u in a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (Acquisition). Immediately before the Acquisition, Asset had a U.S. basis of 100u, and immediately after the Acquisition, Asset had a U.S. basis of 300u. Effective on February 1, Year 1, FT elects to be a disregarded entity pursuant to § 301.7701-3. As a result of the election, FT is deemed, for U.S. income tax purposes, to distribute Asset to CFC in liquidation (Deemed Liquidation) immediately before the closing of the day before the election is effective pursuant to § 301.7701-3(g)(1)(iii) and (3)(ii). The

Deemed Liquidation is disregarded for Country A tax purposes. No gain or loss is recognized on the Deemed Liquidation for either U.S. or Country A tax purposes.

(ii) *Result.* Under § 1.901(m)-2T(b)(1), the Acquisition by CFC of the stock of FT is a section 338 CAA. Under § 1.901(m)-2T(c)(1), Asset is an RFA with respect to Country A tax and the Acquisition, because immediately after the Acquisition, Asset is relevant in determining foreign income of FT for Country A tax purposes, and FT owned Asset when the Acquisition occurred. Under § 1.901(m)-4T(b), the basis difference with respect to Asset is 200u (300u - 100u). Under § 1.901(m)-2T(b)(2), the Deemed Liquidation is a CAA (subsequent CAA) because the Deemed Liquidation is treated as an acquisition of assets for U.S. income tax purposes and is disregarded for Country A tax purposes. Because the U.S. basis in Asset is 300u immediately before and after the Deemed Liquidation, the subsequent CAA does not give rise to any additional basis difference. The Deemed Liquidation is not a disposition under § 1.901(m)-1T(a)(10) because it did not result in gain or loss being recognized with respect to Asset for U.S. or Country A tax purposes. Accordingly, no basis difference with respect to Asset is taken into account under § 1.901(m)-5T as a result of the Deemed Liquidation, and the unallocated basis difference with respect to Asset immediately after the Deemed Liquidation is 200u (200u - 0u). Under paragraph (b)(2) of this section, the Deemed Liquidation is a successor transaction because there is a transfer of Asset for U.S. income tax purposes from FT to CFC and Asset has unallocated basis difference with respect to the Acquisition immediately

after the Deemed Liquidation. Accordingly, under paragraph (b)(1) of this section, section 901(m) will continue to apply to the unallocated basis difference with respect to Asset until the entire 200u basis difference has been taken into account under § 1.901(m)-5T.

(c) *Successor rules for aggregate basis difference carryover* [Reserved].

(d) *Effective/applicability date.* (1) Paragraphs (a), (b)(1), (b)(2), (b)(4)(i), (b)(4)(iii), and (b)(5) of this section apply to CAAs occurring on or after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election made under § 301.7701-3 of this chapter that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014. Paragraphs (a), (b)(1), (b)(2), (b)(4)(i), (b)(4)(iii), and (b)(5) of this section also apply to CAAs occurring on or after January 1, 2011, and before July 21, 2014, other than CAAs occurring before July 21, 2014, resulting from an entity classification election made under § 301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, but only with respect to basis difference determined under § 1.901(m)-4T(e) with respect to the CAA.

(2)-(3) [Reserved].

(e) *Expiration date.* The applicability of this section expires on December 6, 2019.

Par. 8. Sections 1.901(m)-7T and 1.901(m)-8T are added and reserved to read as follows:

§ 1.901(m)-7T *De minimis rules.*  
[Reserved].

§ 1.901(m)-8T *Miscellaneous.*  
[Reserved].

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

Approved: November 4, 2016.

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

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# Part III. Administrative, Procedural, and Miscellaneous

## Treatment of Certain Triangular Reorganizations Involving Foreign Corporations; Amount of Income Inclusion in Certain Inbound Nonrecognition Transactions

### Notice 2016-73

#### SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue regulations under section 367 of the Internal Revenue Code (Code) to modify the rules relating to the treatment of property used to acquire parent stock or securities in certain triangular reorganizations involving one or more foreign corporations, and the consequences to persons that receive parent stock or securities pursuant to such triangular reorganizations. This notice also announces that the Treasury Department and the IRS intend to issue regulations under section 367 to modify the amount of an income inclusion required in certain inbound nonrecognition transactions.

#### SECTION 2. BACKGROUND

##### *.01 Section 367(a)*

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person (U.S. person) transfers property to a foreign corporation, the foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. Sections 367(a)(2), (3), and (6) provide exceptions to the general rule of section 367(a)(1) and grant regulatory authority to the Secretary to provide additional exceptions and to limit the statutory exceptions.

##### *.02 Section 367(b)*

Section 367(b)(1) provides that, in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in con-

nection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary that are necessary or appropriate to prevent the avoidance of U.S. federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a U.S. person, including regulations providing the circumstances under which gain is recognized or deferred, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to the basis of stock or securities.

##### *.03 Section 1.367(b)-10*

###### *(a) In General*

Section 1.367(b)-10 (final regulations) applies to certain triangular reorganizations in which a subsidiary (S) acquires stock or securities of its parent corporation (P) in exchange for property (the P acquisition), and S exchanges the P stock or securities so acquired for stock, securities, or property of a target corporation (T). The final regulations do not apply unless P or S (or both) is a foreign corporation. The application of the final regulations is also subject to certain exceptions, including the section 367(a) priority rule discussed below.

When applicable to a triangular reorganization, the final regulations require that adjustments be made that have the effect of a distribution of property from S to P under section 301 (deemed distribution). § 1.367(b)-10(b)(1). For this purpose, the amount of the deemed distribution generally is the amount of property that was transferred by S to acquire the P stock and securities in the P acquisition. *Id.* For purposes of making the required adjustments, the final regulations treat the deemed distribution as a separate transaction that occurs before the P acquisition or, if P does not control S at the time of the P acquisition, immediately after P acquires control

of S, but before the triangular reorganization. § 1.367(b)-10(b)(3).

The term property for purposes of the final regulations has the meaning set forth in section 317(a) (that is, money, securities, and any other property, other than stock in the corporation making the distribution), as modified to take into account certain assumed liabilities and S stock or rights used by S to acquire P stock or securities from a person other than P. § 1.367(b)-10(a)(3)(ii).

###### *(b) Priority Rules*

Section 1.367(b)-10(a)(2)(iii) provides that the final regulations do not apply to a triangular reorganization if, in an exchange under section 354 or 356, one or more U.S. persons exchange stock or securities of T and the amount of gain in the T stock or securities recognized by such U.S. persons under section 367(a)(1) is equal to or greater than the sum of the amount of the deemed distribution that would be treated by P as a dividend under section 301(c)(1) and the amount of such deemed distribution that would be treated by P as gain from the sale or exchange of property under section 301(c)(3) (together, section 367(b) income) if the final regulations otherwise would apply to the triangular reorganization (section 367(a) priority rule).

Section 1.367(a)-3(a)(2)(iv) provides a similar priority rule that turns off the application of section 367(a)(1) to an exchange under section 354 or 356 that occurs in connection with a triangular reorganization described in the final regulations if the amount of gain that otherwise would be recognized under section 367(a)(1) (without regard to any exceptions thereto) is less than the amount of the section 367(b) income recognized under the final regulations (section 367(b) priority rule).

###### *(c) Anti-Abuse Rule*

The final regulations provide that appropriate adjustments shall be made if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of the final

regulations (anti-abuse rule). § 1.367(b)–10(d). The anti-abuse rule sets forth one example, which provides that the earnings and profits of S will be deemed to include the earnings and profits of a corporation related to P or S for purposes of determining the consequences of the adjustments provided in the final regulations, if S is created, organized, or funded to avoid the application of the final regulations with respect to the earnings and profits of that related corporation. Id.

(d) *Notice 2014–32*

On April 25, 2014, the Treasury Department and the IRS issued Notice 2014–32 (2014–20 IRB 1006) (2014 notice), which announced the intention to issue regulations modifying and clarifying the final regulations. The 2014 notice addressed, in part, certain inversion transactions that were structured to be subject to the final regulations in order to avoid shareholder-level gain recognition under section 367(a)(1) by reason of the section 367(b) priority rule, notwithstanding that only a minimal amount of income was subject to U.S. tax by reason of a deemed distribution under the final regulations. The 2014 notice announced that the final regulations would be modified to provide that section 367(b) income includes a section 301(c)(1) dividend or section 301(c)(3) gain that would arise if the final regulations applied to the triangular reorganization only to the extent such dividend income or gain would be subject to U.S. tax or would give rise to an income inclusion under section 951(a)(1)(A) that would be subject to U.S. tax.

The 2014 notice also announced that the anti-abuse rule would be clarified to provide that S’s acquisition of P stock or securities in exchange for a note may invoke the anti-abuse rule, and that the earnings and profits of a corporation (or a successor corporation) may be taken into account for purposes of determining the consequences of the adjustments provided in the final regulations, as modified by the rules announced in the notice, regardless of whether such corporation is related to P or S before the triangular reorganization.

Finally, the 2014 notice announced that the anti-abuse rule would be clarified to provide that a funding of S may occur

after the triangular reorganization and that a funding of S could include capital contributions, loans, and distributions.

*.04 Sections 1.367(b)–4 and 1.367(b)–4T*

Sections 1.367(b)–4 and 1.367(b)–4T apply to certain acquisitions by a foreign corporation of the stock or assets of a foreign corporation (referred to in those regulations and this notice as the “foreign acquired corporation”) in an exchange described in section 351 or in a reorganization described in section 368(a)(1). Sections 1.367(b)–4T(b) and 1.367(b)–4(b) (1) provide that, if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation by another foreign corporation in an exchange subject to section 367(b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount attributable to the stock of the foreign acquired corporation exchanged. However, the scope and purpose of the grant of authority in section 367(b) are not limited to the preservation of section 1248 amounts, and the regulations thereunder are not limited to requiring an inclusion of the section 1248 amount with respect to the stock of a foreign acquired corporation exchanged. Section 367(b) provides the Treasury Department and the IRS broad authority to issue regulations applicable to nonrecognition transactions that are “necessary or appropriate to prevent the avoidance of Federal income taxes,” including regulations that prescribe “the circumstances under which gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both.”

*.05 Inbound Transactions and the All Earnings and Profits Amount*

Section 1.367(b)–3 applies when a foreign corporation transfers assets to a domestic corporation pursuant to either a liquidation described in section 332 or an asset reorganization described in section 368 (in each case, an “inbound transaction”). Section 1.367(b)–3(a) and this notice refer to such foreign corporation as the “foreign acquired corporation” and

such domestic corporation as the “domestic acquiring corporation.” When there is an inbound transaction, in general, § 1.367(b)–3 requires certain shareholders (including certain foreign corporate shareholders) of the foreign acquired corporation to include in income as a deemed dividend the all earnings and profits amount with respect to their stock. Under § 1.367(b)–2(d), the all earnings and profits amount of a foreign acquired corporation is determined under the principles of section 1248 for computing the amount of earnings and profits attributable to stock, with certain modifications. For example, the all earnings and profits amount does not take into account earnings and profits of foreign subsidiaries of the foreign acquired corporation, notwithstanding section 1248(c)(2). § 1.367(b)–2(d)(3)(ii).

Section 1.367(b)–3 is intended to ensure that a domestic acquiring corporation does not succeed to the basis in the assets of the foreign acquired corporation except to the extent that a U.S. person that is a shareholder (including indirect ownership through certain foreign corporate shareholders) of the foreign acquired corporation has been subject to U.S. tax on its share of the earnings and profits that gave rise, in whole or in part, to the basis. See, for example, the discussion concerning inbound transactions in the preambles to TD 8862 (65 FR 3589–01, 2000–1 CB 466) and proposed regulations issued in 1991 (56 FR 41993, 1991–2 CB 1070). The definition of the all earnings and profits amount, in particular its limitation with respect to the earnings and profits of subsidiaries, is premised on an assumption that the basis in the assets of the foreign acquired corporation reflects solely the earnings and profits of the foreign acquired corporation, the liabilities of the foreign acquired corporation, and capital acquired from a shareholder.

*.06 Nonqualified Preferred Stock*

Section 351(g)(1) provides, in relevant part, that section 351(a) does not apply to a transfer of property in exchange for nonqualified preferred stock, as defined in section 351(g)(2).

### SECTION 3. TRANSACTIONS AT ISSUE

The Treasury Department and the IRS are aware that taxpayers are engaging in transactions designed to repatriate earnings and basis of foreign corporations without incurring U.S. tax by exploiting the section 367(a) priority rule, as modified by the 2014 notice. In one such transaction, USP, a domestic corporation, wholly owns FP, a foreign corporation, which, in turn, wholly owns FS, another foreign corporation. FP has no earnings and profits, but FS has substantial earnings and profits. A dividend from FS to FP would qualify for the exception to foreign personal holding company income under section 954(c)(6). USP also wholly owns USS, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation. Pursuant to a transaction undertaken for the purported business purpose of integrating FT into the FP-FS ownership chain, FS acquires FP stock from FP in exchange for cash, a note, or other property (the FP acquisition) and uses the FP stock to acquire all of the stock of FT from USS in a transaction intended to qualify as a reorganization described in section 368(a)(1)(B) (FT reorganization). On a later date, and purportedly unrelated to the FT reorganization, FP engages in an inbound transaction described in § 1.367(b)-3, for example, a transfer of all of FP's assets, including the cash, note, or other property received from FS, to USP or a domestic subsidiary of USP.

In this transaction, the transfer by USS of the FT stock to FS in exchange for stock of FP pursuant to the FT reorganization is an indirect stock transfer described in § 1.367(a)-3(d)(1)(iii)(A). Pursuant to § 1.367(a)-3(b), the taxpayer files a gain recognition agreement under § 1.367(a)-8 with respect to USS's transfer of FT stock on all but a de minimis amount of FT stock, and, with respect to that de minimis amount of FT stock, recognizes a small amount of gain under section 367(a)(1). Furthermore, the taxpayer applies the priority rules by comparing the section 367(b) income to the de minimis amount of gain under section 367(a)(1) to determine whether the final regulations apply to the FP acquisition. In computing the amount of section 367(b) income for

purposes of the section 367(a) priority rule, the taxpayer takes the position that a deemed distribution from FS to FP would not result in section 367(b) income, as described in the 2014 notice, because any dividend income to FP would not be subject to U.S. tax and would not give rise to an income inclusion under section 951(a)(1)(A) by reason of section 954(c)(6). Accordingly, the taxpayer takes the position that the section 367(b) income (which, under this position, is zero) does not exceed the section 367(a) gain and, therefore, the final regulations do not apply to the FP acquisition by reason of the section 367(a) priority rule. Furthermore, the taxpayer takes the position that the subsequent inbound transaction with respect to FP results in no income inclusion to USP under § 1.367(b)-3 because FP's earnings and profits are not increased under the final regulations and thus FP's all earnings and profits amount is zero. Finally, the taxpayer takes the position that the anti-abuse rule does not apply in this case for various reasons that may include: (1) the FP acquisition is not engaged in with a view to avoid the purpose of the final regulations because it is engaged in for the purpose of integrating FT into the FP-FS chain; (2) the FP acquisition is not a transaction that occurs in connection with the FT reorganization because the acquisition is specifically contemplated by the final regulations; (3) the inbound transaction with respect to FP does not occur in connection with the FT reorganization because it does not occur pursuant to the same plan as the FT reorganization; or (4) the anti-abuse rule only applies to adjust the earnings and profits of FS to take into account the earnings and profits of another corporation and, in this regard, FS is not created, organized, or funded to avoid the purpose of the final regulations with respect to the earnings and profits of another corporation.

The Treasury Department and the IRS also are aware of a similar transaction in which taxpayers take advantage of the rule in section 951(a)(1)(A) that requires a U.S. shareholder to include in its gross income its pro rata share of the subpart F income of a foreign corporation only if the foreign corporation has been a controlled foreign corporation for an uninterrupted period of 30 days or more during the

taxable year (the 30-day rule). In this form of the transaction, FP is formed, and the FP acquisition occurs, during the final 29 days of FP's taxable year. In computing the amount of section 367(b) income for purposes of the section 367(a) priority rule in this transaction, the taxpayer takes the position that a deemed distribution from FS to FP would not result in any section 367(b) income, as described in the 2014 notice, because any income recognized by FP (including capital gain under section 301(c)(3)) would not be subject to U.S. tax and would not give rise to an income inclusion under section 951(a)(1)(A) by reason of the 30-day rule.

The Treasury Department and the IRS also are aware of another variation of the transaction intended to repatriate earnings of a foreign corporation without U.S. tax through the use of nonqualified preferred stock. In one such transaction, USP, a domestic corporation, wholly owns both FP, a foreign corporation, and USS, a domestic corporation. USS wholly owns FT, a foreign corporation, which has substantial earnings and profits. FP has no earnings and profits. FP acquires newly-issued stock of USP from USP in exchange for nonqualified preferred stock of FP, and then FP uses the USP stock as consideration to acquire all of the stock of FT from USS in a transaction intended to qualify as a reorganization described in section 368(a)(1)(B). On a subsequent date, when FP still has no earnings and profits, FP redeems the FP nonqualified preferred stock held by USP in exchange for cash or a note.

The taxpayer takes the position that FP's acquisition of USP stock is not subject to the final regulations because the FP nonqualified preferred stock is not "property" within the meaning of § 1.367(b)-10(a)(3)(ii). Furthermore, the taxpayer takes the position that USP's transfer of its own stock to FP in exchange for nonqualified preferred stock does not qualify as an exchange described in section 351 pursuant to section 351(g)(2) and, therefore, USP takes a basis in the FP nonqualified preferred stock equal to its fair market value under § 1.1032-1(d). In addition, the taxpayer takes the position that the redemption of the FP nonqualified preferred stock does not result in dividend income or capital gain to USP under sec-

tion 301(c) because FP does not have earnings and profits and the redemption is applied against and reduces USP's basis in the FP stock under section 301(c)(2). Finally, the taxpayer takes the position that the anti-abuse rule does not apply in such a case for reasons similar to those discussed above in the context of the transaction involving section 954(c)(6).

The Treasury Department and the IRS have determined that these transactions raise significant policy concerns and that the revisions to the regulations described in Section 4 of this notice are necessary or appropriate to prevent the avoidance of U.S. federal income taxes. The Treasury Department and the IRS intend to revise the regulations under section 367 accordingly.

## SECTION 4. REGULATIONS TO BE ISSUED

### .01 Priority Rules

The Treasury Department and the IRS intend to modify the section 367(a) priority rule to apply only when T is a domestic corporation. Accordingly, when T is a foreign corporation, the final regulations, as modified by the rules described in this notice, will apply to a triangular reorganization described in § 1.367(b)-10(a)(1), unless an exception in § 1.367(b)-10(a)(2)(i) or (ii) applies.

The Treasury Department and the IRS intend to modify the section 367(b) priority rule to provide that, in an exchange under section 354 or 356 that occurs in connection with a transaction described in the final regulations, to the extent one or more U.S. persons exchange stock or securities of a foreign corporation for P stock or securities acquired by S in exchange for property (as defined in § 1.367(b)-10(a)(3)(ii), as modified by the regulations described in this notice) in the P acquisition, section 367(a)(1) will not apply to such U.S. persons with respect to the exchange of the stock or securities of the foreign corporation. Instead, the exchange will be subject to §§ 1.367(b)-4 and 1.367(b)-4T, as modified by the regulations described in this notice. The section 367(b) priority rule, as modified by the regulations described in the 2014 notice, will continue to apply when T is a domestic corporation. In addition, section

367(a) will apply to the exchange of stock or securities of a foreign corporation to the extent such T stock or securities are exchanged for P stock or securities that are not acquired by S in exchange for property (as defined in § 1.367(b)-10(a)(3)(ii), as modified by this notice) in connection with a transaction described in § 1.367(b)-10.

### .02 Sections 1.367(b)-4 and 1.367(b)-4T

The Treasury Department and the IRS intend to modify §§ 1.367(b)-4 and 1.367(b)-4T to provide that, in an exchange under section 354 or 356 that occurs in connection with a transaction described in the final regulations, to the extent an exchanging shareholder exchanges stock or securities of a foreign acquired corporation for P stock or securities acquired by S in exchange for property (defined in § 1.367(b)-10(a)(3)(ii), as modified by the regulations described in this notice) in the P acquisition, then such shareholder must:

(i) Include in income as a deemed dividend the section 1248 amount attributable to the stock of the foreign acquired corporation that it exchanges; and

(ii) After taking into account the increase in basis provided in § 1.367(b)-2(e)(3)(ii) resulting from the deemed dividend (if any), recognize all realized gain with respect to the stock or securities of the foreign acquired corporation exchanged that would not otherwise be recognized.

For purposes of the preceding paragraph, an exchanging shareholder is a U.S. person or foreign person that exchanges stock of a foreign acquired corporation in a prescribed exchange, regardless of whether such U.S. person is a section 1248 shareholder or such foreign person is a foreign corporation in which a U.S. person is a section 1248 shareholder.

### .03 All Earnings and Profits Amount

#### (a) General Rule

The Treasury Department and the IRS intend to modify § 1.367(b)-2(d)(3)(ii) to provide that, if there is excess asset basis with respect to a foreign acquired corporation, then, in the case of an exchanging

shareholder to which § 1.367(b)-3(b)(3) applies, the all earnings and profits amount with respect to the stock in the foreign acquired corporation that it exchanges will be increased by the specified earnings with respect to such stock (if any).

#### (b) Excess Asset Basis

The term *excess asset basis* means, with respect to a foreign acquired corporation, the amount by which the inside asset basis of the foreign acquired corporation exceeds the sum of the following amounts:

(i) The earnings and profits of the foreign acquired corporation attributable to the outstanding stock of the foreign acquired corporation. For this purpose, the earnings and profits attributable to stock of the foreign acquired corporation is determined under the principles of § 1.367(b)-2(d) but without regard to whether the exchanging shareholder is described in § 1.367(b)-3(b)(1) or is a U.S. person or a foreign person. Furthermore, the earnings and profits of the foreign acquired corporation will include amounts described in section 1248(d)(3) or 1248(d)(4).

(ii) The aggregate basis in the outstanding stock of the foreign acquired corporation determined immediately before the inbound transaction and without regard to any basis increase described in § 1.367(b)-2(e)(3)(ii) resulting from such inbound transaction.

(iii) The aggregate amount of liabilities of the foreign acquired corporation that are assumed by the domestic acquiring corporation in the inbound transaction determined under the principles of section 357(d).

#### (c) Inside Asset Basis

The term *inside asset basis* means, with respect to a foreign acquired corporation, the adjusted basis of the assets of the foreign acquired corporation in the hands of the domestic acquiring corporation determined immediately after the inbound transaction.

#### (d) *Specified Earnings*

The term *specified earnings* means, with respect to the stock of a foreign acquired corporation that is exchanged by an exchanging shareholder, the lesser of the following amounts (but not below zero):

(i) The sum of the earnings and profits (including a deficit) with respect to each foreign subsidiary of the foreign acquired corporation that are attributable under section 1248(c)(2) to the stock of the foreign acquired corporation exchanged. For purposes of the preceding sentence, the modifications described in § 1.367(b)–2(d)(2) and (d)(3)(i) apply. Thus, for example, the amount of the earnings and profits of a foreign subsidiary that are attributable to stock of the foreign acquired corporation is determined without regard to whether the foreign subsidiary was a controlled foreign corporation at any time during the five years preceding the inbound transaction. The amount described in this Section 4.03(d)(i) is referred to in this notice as the “lower-tier earnings.”

(ii) The product of the excess asset basis of the foreign acquired corporation, multiplied by the exchanging shareholder’s specified percentage.

(iii) The amount of gain that would be realized by the exchanging shareholder if, immediately before the inbound transaction, the exchanging shareholder had sold the stock of the foreign acquired corporation for fair market value, reduced by the exchanging shareholder’s all earnings and profits amount (for this purpose, determined without regard to the modifications described in this notice). The amount described in this Section 4.03(d)(iii) is referred to in this notice as the “specified stock gain.”

#### (e) *Specified Percentage*

The term *specified percentage* means, with respect to an exchanging shareholder, a fraction (expressed as a percentage), the numerator of which is the amount of the exchanging shareholder’s specified stock gain, and the denominator of which is the sum of the aggregate of the specified stock gain with respect to all exchanging shareholders to which § 1.367(b)–3(b)(3) applies and the aggregate of the gain realized (regardless of whether

such gain is recognized) with respect to the stock exchanged by all other exchanging shareholders.

#### (f) *Source of Specified Earnings*

If the specified earnings attributable to the stock of a foreign acquired corporation exchanged by an exchanging shareholder is less than the lower-tier earnings attributable to the stock exchanged, the specified earnings of the exchanging shareholder will be sourced from lower-tier earnings of foreign subsidiaries of the foreign acquired corporation under the principles of § 1.1248–1(d)(3).

#### (g) *Adjustments to Excess Asset Basis*

If there is excess asset basis with respect to a foreign acquired corporation, as determined under Section 4.03(b) of this notice, a taxpayer may reduce the excess asset basis to the extent that the excess asset basis is not attributable, directly or indirectly, to property provided by a foreign subsidiary of the foreign acquired corporation. For example, if there was a transfer of property to the foreign acquired corporation described in section 362(e)(2), and the election described in section 362(e)(2)(C) was made to limit the basis in the stock received in the foreign acquired corporation to its fair market value, then, for purposes of determining excess asset basis, the basis in the stock of the foreign acquiring corporation may be determined without regard to the application of section 362(e)(2).

For purposes of this Section 4.03(g), property used by a foreign subsidiary to purchase the stock of the foreign acquired corporation in connection with a triangular reorganization is treated as property provided by the foreign subsidiary. In addition, the term property has the meaning provided in § 1.367(b)–10(a)(3)(ii), as modified by this notice. Finally, a reference to a foreign acquired corporation or foreign subsidiary includes a predecessor of the foreign acquired corporation or foreign subsidiary.

#### (h) *Anti-Abuse Rule*

The regulations to be issued under § 1.367(b)–3 will include an anti-abuse rule to address transactions engaged in with a view to avoid the purposes of the

rules described in this Section 4.03. Under the anti-abuse rule, adjustments must be made, including by disregarding the effects of transactions, to carry out the purposes of this section. Thus, as one example, if a transaction is engaged in with a view to reduce excess asset basis, including by increasing the basis in the stock of the foreign acquired corporation without a corresponding increase in the basis in the assets of the foreign acquired corporation, that increase in the basis in the stock of the foreign acquired corporation will be disregarded for purposes of computing excess asset basis.

#### .04 *Nonqualified Preferred Stock*

The definition of property provided in § 1.367(b)–10(a)(3)(ii) will be modified to include S stock that is nonqualified preferred stock (as defined in section 351(g)(2)).

#### .05 *Examples*

The following examples illustrate certain modifications to the final regulations described in this Section 4:

*Example 1. (i) Facts.* USP, a domestic corporation, wholly owns FP and USS. FP is a foreign corporation that wholly owns FS, a foreign corporation. USS is a domestic corporation that wholly owns FT, a foreign corporation. USS owns 100 shares of FT stock, which constitutes a single block of stock with a fair market value of \$100x, an adjusted basis of \$20x, and a section 1248 amount of \$50x. FS has earnings and profits of \$60x. A dividend from FS to FP would qualify for the exception to foreign personal holding company income under section 954(c)(6). FP issues 100 shares of voting stock with a fair market value of \$100x to FS in exchange for \$40x of common stock of FS and \$60x cash. FS acquires all of the stock of FT held by USS solely in exchange for the \$100x of FP voting stock in a triangular reorganization described in section 368(a)(1)(B).

(ii) *Analysis.* The triangular reorganization is described in § 1.367(b)–10(a). Pursuant to § 1.367(b)–10(b)(1), as modified by the rules announced in the 2014 notice, adjustments must be made that have the effect of a distribution of property in the amount of \$60x from FS to FP under section 301. The \$60x deemed distribution is treated as separate from, and occurring immediately before, FS’s acquisition of the \$60x of FP stock used in the triangular reorganization. The \$60x deemed distribution from FS to FP results in \$60x dividend income to FP under section 301(c)(1) that is not subpart F income under section 954(c)(6). Pursuant to Section 4.01 of this notice, § 1.367(b)–4 (as modified by Section 4.02 of

this notice), rather than section 367(a)(1), applies to the \$60x of FT stock exchanged for the \$60x of FP stock acquired by FS from FP in exchange for \$60x cash. Thus, USS must include in income a \$30x deemed dividend (\$50x section 1248 amount x 60%) with respect to the FT stock exchanged for FP stock that was acquired by FS from FP for \$60x cash. In addition, USS must recognize the remaining \$18x gain (\$48x gain ((\$80x gain x 60%) - \$30x deemed dividend) realized with respect to such FT stock. If USS properly files a gain recognition agreement pursuant to §§ 1.367(a)-3(b)(2) and 1.367(a)-8, USS does not recognize gain under section 367(a)(1) with respect to the \$40x of FT stock exchanged for FP stock that was acquired by FS from FP in exchange for the \$40x of FS common stock.

*Example 2. (i) Facts.* USP, a domestic corporation, owns 90% of the stock of FP, a foreign corporation. The remaining 10% of the stock of FP is owned by FI, a nonresident alien individual unrelated to USP. FP is a foreign corporation that wholly owns FS1, a foreign corporation, which, in turn, wholly owns FS2, a foreign corporation. The FP stock owned by USP has a fair market value of \$90x and an adjusted basis of \$17x. The FP stock owned by FI has a fair market value of \$10x and an adjusted basis of \$6x. The all earnings and profits amount with respect to USP's FP stock, determined without regard to this notice, is \$27x. The assets of FP have an adjusted basis of \$78x, FP has no liabilities, and the earnings and profits of FP attributable to the outstanding FP stock is \$30x (in this case, as determined under the principles of § 1.367(b)-2(d) but without regard to whether USP and FI are exchanging shareholders described in § 1.367(b)-3(b)(1) or U.S. or foreign persons). The earnings and profits of FS1 and FS2 attributable to the FP stock owned by USP under section 1248(c)(2) (as determined under the principles of § 1.367(b)-2(d)(2) and (d)(3)(i)) are \$80x and (\$20x) respectively. In a reorganization described in section 368(a)(1)(F), US Newco, a newly-formed domestic corporation that is wholly owned by USP, acquires all of the assets of FP solely in exchange for stock of US Newco. No adjustment under Section 4.03(g) of this notice is appropriate.

(ii) *Analysis—(A) All earnings and profits amount.* Under § 1.367(b)-3(b)(3), USP must include in income as a deemed dividend the all earnings and profits amount with respect to its FP stock. Pursuant to Section 4.03 of this notice, the all earnings and profits amount of \$27x, determined without regard to this notice, is increased by the specified earnings of FP, because there is excess asset basis with respect to FP determined as follows.

(B) *Excess asset basis.* The amount of the excess asset basis is \$25x, the amount that the inside asset basis of FP (\$78x) exceeds the sum of (i) the earnings and profits of FP (\$30x), (ii) the aggregate basis in all of the FP stock (\$23x), and (iii) the liabilities of FP assumed by US Newco (\$0x).

(C) *Specified earnings.* The specified earnings with respect to the stock of FP exchanged by USP equals \$23x, the lesser of the following amounts (but not below zero) (i) \$60x, the sum of the earnings and profits (including deficits) with respect to FS1 and FS2 attributable under section 1248(c)(2) to the stock of FP exchanged by USP; (ii) \$23x, the product of the excess asset basis with respect to FP (\$25x), multiplied by USP's specified percentage (92%), determined based on a fraction, the numerator of which is USP's specified stock gain (\$46x), and the denominator of which is the sum of the aggregate of the specified stock gain and gain realized with respect to FP stock (\$50x), and (iii) \$46x, USP's specified stock gain, which is the amount of gain that would be realized by USP if immediately before the inbound transaction USP had sold the stock of FP for fair market value (\$73x), reduced by USP's all earnings and profits amount (determined without regard to the modifications described in this notice) (\$27x).

(D) *All earnings and profits amount, as modified by this notice.* The all earnings and profits amount that USP must include in income as a deemed dividend is \$50x (\$27x + \$23). Under § 1.367(b)-2(e)(2), \$23x of the deemed dividend is determined by reference to the earnings and profits of FS1 and is considered as having been paid by FS1 to USP through FP. Under § 1.367(b)-2(e)(3)(ii), immediately before the exchange, USP's basis in the stock of FP is increased by the amount of the \$50x deemed dividend for purposes of determining USP's basis in its stock of US Newco. However, the basis increase under § 1.367(b)-2(e)(3)(ii) is not taken into account for purposes of calculating USP's all earnings and profits amount, as modified by Section 4.03 of this notice.

## SECTION 5. EFFECTIVE DATE

The regulations described in Section 4 of this notice will apply to transactions completed on or after December 2, 2016, and to any inbound transactions treated as completed before December 2, 2016 as a result of an entity classification election made under § 301.7701-3 of this chapter that is filed on or after December 2, 2016. No inference is intended regarding the treatment of transactions described in Section 3 of this notice under current law. For example, these transactions are currently subject to challenge under the anti-abuse rule.

## SECTION 6. COMMENTS

The Treasury Department and the IRS request comments on the rules described in this notice. In particular, § 1.367(b)-10(b)(3) currently provides that the deemed distribution described in § 1.367(b)-10(b)(1) is treated as occurring immediately before the P acquisition.

Comments are requested on whether, in light of the modifications announced by this notice, it may be more appropriate (in particular, when T is a foreign corporation) to treat the deemed distribution as occurring immediately after, rather than before, the triangular reorganization. In addition, comments are requested as to whether any specific adjustments to excess asset basis should be allowed, or not allowed, consistent with the principles underlying Section 4.03 of this notice. Finally, comments are requested as to whether there are transactions other than those described in Section 3 of this notice that may give rise to excess asset basis.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Lynlee Baker, Internal Revenue Service, IR-4554, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to [Notice.comments@irs.counsel.treas.gov](mailto:Notice.comments@irs.counsel.treas.gov). Comments will be available for public inspection and copying. Written or electronic comments must be received by March 2, 2017.

## SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Lynlee Baker of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Ms. Baker at (202) 317-6937 (not a toll-free number).

# Satisfying the Required Qualified Allocation Plan Preference in Section 42(m)(1)(B)(ii)(III) (Concerning Concerted Community Revitalization Plans)

## Notice 2016-77

### PURPOSE

This notice reminds taxpayers that a project is not described in § 42(m)(1)(B)(ii)(III) of the Internal Revenue Code unless its development contributes to a concerted community revitalization plan.

### BACKGROUND

Section 42 sets forth rules for determining a building's amount of the low-income housing credit (LIHTC), which § 38 allows as a credit against income tax.

Section 42(h)(1)(A) provides that the amount of the credit determined under § 42 for any taxable year for any building may not exceed the housing credit dollar amount allocated to the building.

Section 42(m) requires every allocation of housing credit dollar amount to be made pursuant to a qualified allocation plan (QAP). The Code specifies certain preferences and selection criteria that each QAP must contain.

Section 42(m)(1)(B)(ii) requires every QAP to contain three preferences. Under the third of these, the QAP must give "preference in allocating housing credit dollar amounts among selected projects to . . . projects which are located in qualified census tracts . . . and the development of which contributes to a concerted community revitalization plan. . . ." Section 42(m)(1)(B)(ii)(III) (emphasis added). Qualified census tracts are designated by the U.S. Department of Housing and Urban Development and are characterized by either the percentage of households below a certain income threshold or by a poverty rate above a certain threshold.

In some cases, state or local agencies allocating housing credit dollar amounts have given preference to projects that are located in qualified census tracts without regard to whether the projects contribute to a concerted community revitalization

plan. In some other cases, because development of new multifamily housing benefits a neighborhood, the development of a LIHTC project, without more, has been treated as if it were such a plan.

### DISCUSSION

Placing LIHTC projects in qualified census tracts risks exacerbating concentrations of poverty. Therefore, § 42(m)(1)(B)(ii)(III) grants a preference to that placement only when there is an added benefit to the neighborhood in the form of the project's contribution to a concerted community revitalization plan.

Although the Department of the Treasury and the Internal Revenue Service (the Service) have not issued guidance defining the term "concerted community revitalization plan," the preference fails to apply unless, not later than the allocation, a plan exists that contains more components than the LIHTC project itself.

### REQUEST FOR COMMENTS

The Department of the Treasury and the Service are considering providing guidance to clarify the preference in § 42(m)(1)(B)(ii)(III), and they request comments from the public regarding the contents of that guidance. Comments should be submitted by February 10, 2017. Comments may be mailed to:

Internal Revenue Service  
Attn: CC:PA:LPD:PR (Notice 2016-77)  
Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

or hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Courier's Desk  
Internal Revenue Service  
Attn: CC:PA:LPD:PR (Notice 2016-77)  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Alternatively, persons may submit comments electronically via e-mail to the following address:

*Notice.Comments@irs.counsel.treas.gov.*  
Persons should include "Notice 2016-77"

in the subject line. All comments submitted by the public will be available for public inspection and copying in their entirety.

### DRAFTING INFORMATION

The principal author of this notice is James W. Rider, Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, please contact Mr. Rider at (202) 317-4137 (not a toll-free number).

## Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

### Notice 2016-78

This notice provides guidance on the corporate bond monthly yield curve, the corresponding spot segment rates used under § 417(e)(3), and the 24-month average segment rates under § 430(h)(2) of the Internal Revenue Code. In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning before 2008 and the 30-year Treasury weighted average rate under § 431(c)(6)(E)(ii)(I).

### YIELD CURVE AND SEGMENT RATES

Generally, except for certain plans under sections 104 and 105 of the Pension Protection Act of 2006 and CSEC plans under § 414(y), § 430 of the Code specifies the minimum funding requirements that apply to single-employer plans pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan's target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates ("segment rates"), each of which applies to cash flows during specified periods. To the extent provided under § 430(h)(2)(C)(iv), these segment rates are adjusted by the applicable percentage of the 25-year average segment rates for the period ending September 30 of the year preced-

ing the calendar year in which the plan year begins.<sup>1</sup> However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates.

Notice 2007–81, 2007–44 I.R.B. 899, provides guidelines for determining the monthly corporate bond yield curve, and the 24-month average corporate bond segment rates used to compute the target normal cost and the funding target. Consistent with the methodology specified in Notice 2007–81, the monthly corporate bond yield curve derived from November 2016 data is in Table I at the end of this

notice. The spot first, second, and third segment rates for the month of November 2016 are, respectively, 1.79, 3.80, and 4.71.

The 24-month average segment rates determined under § 430(h)(2)(C)(i) through (iii) must be adjusted pursuant to § 430(h)(2)(C)(iv) to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates. For plan years beginning before 2021, the applicable minimum percentage is 90% and the applicable maximum percentage is 110%. The 25-year average segment rates for plan years beginning in

2015, 2016, and 2017 were published in Notice 2014–50, 2014–40 I.R.B. 590, Notice 2015–61, 2015–39 I.R.B. 408, and Notice 2016–54, 2016–40 I.R.B. 429, respectively.

### 24-MONTH AVERAGE CORPORATE BOND SEGMENT RATES

The three 24-month average corporate bond segment rates applicable for December 2016 without adjustment for the 25-year average segment rate limits are as follows:

Applicable Month	First Segment	Second Segment	Third Segment
December 2016	1.55	3.76	4.73

Based on § 430(h)(2)(C)(iv), the 24-month averages applicable for December 2016 adjusted to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates, are as follows:

For Plan Years Beginning In	Adjusted 24-Month Average Segment Rates				
	Applicable Month		First Segment	Second Segment	Third Segment
2015	December	2016	4.72	6.11	6.81
2016	December	2016	4.43	5.91	6.65
2017	December	2016	4.16	5.72	6.48

### 30-YEAR TREASURY SECURITIES INTEREST RATES

Generally for plan years beginning after 2007, § 431 specifies the minimum funding requirements that apply to multiemployer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in § 431(c)(6)(A), based on the plan’s current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this

purpose must be no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate. The rate of interest on 30-year Treasury securities for November 2016 is 2.86 percent. The Service determined this rate as the average of the daily determinations of yield on the 30-

year Treasury bond maturing in August 2046 determined each day through November 9, 2016 and the yield on the 30-year Treasury bond maturing in November 2046 determined each day for the balance of the month. For plan years beginning in the month shown below, the weighted average of the rates of interest on 30-year Treasury securities and the permissible range of rate used to calculate current liability are as follows:

<sup>1</sup>Pursuant to § 433(h)(3)(A), the 3<sup>rd</sup> segment rate determined under § 430(h)(2)(C) is used to determine the current liability of a CSEC plan (which is used to calculate the minimum amount of the full funding limitation under § 433(c)(7)(C)).

For Plan Years Beginning in		30-Year Treasury Weighted Average	Permissible Range		
<i>Month</i>	<i>Year</i>		90%	to	105%
December	2016	2.91	2.61		3.05

**MINIMUM PRESENT VALUE  
SEGMENT RATES**

In general, the applicable interest rates under § 417(e)(3)(D) are segment rates

computed without regard to a 24-month average. Notice 2007–81 provides guidelines for determining the minimum present value segment rates. Pursuant to that notice, the minimum present value seg-

ment rates determined for November 2016 are as follows:

First Segment	Second Segment	Third Segment
1.79	3.80	4.71

**DRAFTING INFORMATION**

The principal author of this notice is Tom Morgan of the Office of the Associ-

ate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS participated in the development of this guidance. For further

information regarding this notice, contact Mr. Morgan at 202-317-6700 or Tony Montanaro at 202-317-8698 (not toll-free numbers).

**Table I**  
 Monthly Yield Curve for November 2016  
 Derived from November 2016 Data.

<i>Maturity</i>	<i>Yield</i>								
0.5	0.97	20.5	4.46	40.5	4.74	60.5	4.84	80.5	4.89
1.0	1.24	21.0	4.47	41.0	4.74	61.0	4.84	81.0	4.89
1.5	1.48	21.5	4.48	41.5	4.75	61.5	4.84	81.5	4.89
2.0	1.67	22.0	4.50	42.0	4.75	62.0	4.84	82.0	4.89
2.5	1.82	22.5	4.51	42.5	4.75	62.5	4.85	82.5	4.89
3.0	1.94	23.0	4.52	43.0	4.76	63.0	4.85	83.0	4.89
3.5	2.04	23.5	4.53	43.5	4.76	63.5	4.85	83.5	4.89
4.0	2.14	24.0	4.54	44.0	4.76	64.0	4.85	84.0	4.90
4.5	2.25	24.5	4.55	44.5	4.77	64.5	4.85	84.5	4.90
5.0	2.36	25.0	4.55	45.0	4.77	65.0	4.85	85.0	4.90
5.5	2.48	25.5	4.56	45.5	4.77	65.5	4.85	85.5	4.90
6.0	2.60	26.0	4.57	46.0	4.77	66.0	4.86	86.0	4.90
6.5	2.73	26.5	4.58	46.5	4.78	66.5	4.86	86.5	4.90
7.0	2.87	27.0	4.59	47.0	4.78	67.0	4.86	87.0	4.90
7.5	3.00	27.5	4.60	47.5	4.78	67.5	4.86	87.5	4.90
8.0	3.13	28.0	4.60	48.0	4.79	68.0	4.86	88.0	4.90
8.5	3.25	28.5	4.61	48.5	4.79	68.5	4.86	88.5	4.90
9.0	3.37	29.0	4.62	49.0	4.79	69.0	4.86	89.0	4.90
9.5	3.48	29.5	4.63	49.5	4.79	69.5	4.86	89.5	4.90
10.0	3.58	30.0	4.63	50.0	4.80	70.0	4.87	90.0	4.91
10.5	3.67	30.5	4.64	50.5	4.80	70.5	4.87	90.5	4.91
11.0	3.76	31.0	4.65	51.0	4.80	71.0	4.87	91.0	4.91
11.5	3.84	31.5	4.65	51.5	4.80	71.5	4.87	91.5	4.91
12.0	3.92	32.0	4.66	52.0	4.81	72.0	4.87	92.0	4.91
12.5	3.98	32.5	4.66	52.5	4.81	72.5	4.87	92.5	4.91
13.0	4.04	33.0	4.67	53.0	4.81	73.0	4.87	93.0	4.91
13.5	4.10	33.5	4.68	53.5	4.81	73.5	4.87	93.5	4.91
14.0	4.14	34.0	4.68	54.0	4.81	74.0	4.88	94.0	4.91
14.5	4.19	34.5	4.69	54.5	4.82	74.5	4.88	94.5	4.91
15.0	4.22	35.0	4.69	55.0	4.82	75.0	4.88	95.0	4.91
15.5	4.26	35.5	4.70	55.5	4.82	75.5	4.88	95.5	4.91
16.0	4.29	36.0	4.70	56.0	4.82	76.0	4.88	96.0	4.91
16.5	4.32	36.5	4.71	56.5	4.82	76.5	4.88	96.5	4.91
17.0	4.34	37.0	4.71	57.0	4.83	77.0	4.88	97.0	4.91
17.5	4.36	37.5	4.71	57.5	4.83	77.5	4.88	97.5	4.92
18.0	4.38	38.0	4.72	58.0	4.83	78.0	4.88	98.0	4.92
18.5	4.40	38.5	4.72	58.5	4.83	78.5	4.89	98.5	4.92
19.0	4.42	39.0	4.73	59.0	4.83	79.0	4.89	99.0	4.92
19.5	4.43	39.5	4.73	59.5	4.84	79.5	4.89	99.5	4.92
20.0	4.45	40.0	4.73	60.0	4.84	80.0	4.89	100.0	4.92

# 2017 Standard Mileage Rates

## Notice 2016-79

### SECTION 1. PURPOSE

This notice provides the optional 2017 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate (FAVR) plan.

### SECTION 2. BACKGROUND

Rev. Proc. 2010-51, 2010-51 I.R.B. 883, provides rules for computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes, and for substantiating, under § 274(d) of the Internal Revenue Code and § 1.274-5 of the Income Tax Regulations, the amount of ordinary and necessary business expenses of local transportation or travel away from home. Taxpayers using the standard mileage rates must comply with Rev. Proc. 2010-51. However, a taxpayer is not required to use the substantiation methods described in Rev. Proc. 2010-51, but instead may substantiate using actual allowable expense amounts if the taxpayer maintains adequate records or other sufficient evidence.

An independent contractor conducts an annual study for the Internal Revenue Service of the fixed and variable costs of operating an automobile to determine the standard mileage rates for business, medical, and moving use reflected in this notice. The standard mileage rate for charitable use is set by § 170(i).

### SECTION 3. STANDARD MILEAGE RATES

The standard mileage rate for transportation or travel expenses is 53.5 cents per mile for all miles of business use (busi-

ness standard mileage rate). See section 4 of Rev. Proc. 2010-51.

The standard mileage rate is 14 cents per mile for use of an automobile in rendering gratuitous services to a charitable organization under § 170. See section 5 of Rev. Proc. 2010-51.

The standard mileage rate is 17 cents per mile for use of an automobile (1) for medical care described in § 213, or (2) as part of a move for which the expenses are deductible under § 217. See section 5 of Rev. Proc. 2010-51.

### SECTION 4. BASIS REDUCTION AMOUNT

For automobiles a taxpayer uses for business purposes, the portion of the business standard mileage rate treated as depreciation is 23 cents per mile for 2013, 22 cents per mile for 2014, 24 cents per mile for 2015, 24 cents per mile for 2016, and 25 cents per mile for 2017. See section 4.04 of Rev. Proc. 2010-51.

### SECTION 5. MAXIMUM STANDARD AUTOMOBILE COST

For purposes of computing the allowance under a FAVR plan, the standard automobile cost may not exceed \$27,900 for automobiles (excluding trucks and vans) or \$31,300 for trucks and vans. See section 6.02(6) of Rev. Proc. 2010-51.

### SECTION 6. EFFECTIVE DATE

This notice is effective for (1) deductible transportation expenses paid or incurred on or after January 1, 2017, and (2) mileage allowances or reimbursements paid to an employee or to a charitable volunteer (a) on or after January 1, 2017, and (b) for transportation expenses the employee or charitable volunteer pays or incurs on or after January 1, 2017.

### SECTION 7. EFFECT ON OTHER DOCUMENTS

Notice 2016-01 is superseded.

### DRAFTING INFORMATION

The principal author of this notice is Bernard P. Harvey of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information on this

notice contact Bernard P. Harvey on (202) 317-7005 (not a toll-free number).

## 2016 Required Amendments List for Qualified Retirement Plans

### Notice 2016-80

#### I. PURPOSE

This notice contains the Required Amendments List for 2016 (2016 RA List). Section 5.05(3) of Rev. Proc. 2016-37, 2016-29 I.R.B. 136, provides that, in the case of an individually designed plan, the remedial amendment period for a disqualifying provision arising as a result of a change in qualification requirements generally is extended to the end of the second calendar year that begins after the issuance of the Required Amendments List (RA List) in which the change in qualification requirements appears. Pursuant to section 5.05(3) of Rev. Proc. 2016-37, this notice provides that December 31, 2018 is the last day of the remedial amendment period with respect to a disqualifying provision arising as a result of a change in qualification requirements that appears on this 2016 RA List. As a result, under sections 8.01 and 5.05(3) of Rev. Proc. 2016-37, December 31, 2018 is also the plan amendment deadline for a disqualifying provision arising as a result of a change in qualification requirements that appears on the 2016 RA List. However, a later date may apply to a governmental plan (as defined in section 414(d)) pursuant to sections 8.01 and 5.06(3) of Rev. Proc. 2016-37.

#### II. BACKGROUND

Section 401(b) of the Internal Revenue Code provides a remedial amendment period during which a plan may be amended retroactively to comply with the qualification requirements under section 401(a). Section 1.401(b)-1 of the Income Tax Regulations describes the disqualifying provisions that may be amended retroactively and the remedial amendment period during which retroactive amendments may be adopted. Those regulations also grant the Commissioner the discretion to designate certain plan provisions as dis-

qualifying provisions and to extend the remedial amendment period.

Rev. Proc. 2016–37 eliminates, as of January 1, 2017, the five-year remedial amendment cycle system for individually designed plans that was set forth in Rev. Proc. 2007–44, 2007–2 C.B. 54.

Sections 5.05(3) and 5.06(3) of Rev. Proc. 2016–37 extend the remedial amendment period for individually designed plans to correct disqualifying provisions that arise as a result of a change in qualification requirements. Under section 5.05(3), the remedial amendment period is extended to the end of the second calendar year that begins after the issuance of the RA List on which the change in qualification requirements appears. Section 5.06(3) provides a special rule for governmental plans (as defined in section 414(d)) that could further extend the remedial amendment period in some cases.

Section 8.01 of Rev. Proc. 2016–37 provides that the plan amendment deadline with respect to a disqualifying provision described in section 5 of Rev. Proc. 2016–37 is the date on which the remedial amendment period ends with respect to that disqualifying provision.

Section 9 of Rev. Proc. 2016–37 provides that the Department of the Treasury (the Treasury Department) and the Internal Revenue Service (IRS) intend to publish annually an RA List. In general, a change in qualification requirements will not appear on an RA List until guidance with respect to that change (including, in certain cases, model amendments) has been provided in regulations or in other guidance published in the Internal Revenue Bulletin. However, in the discretion of the Treasury Department and the IRS, a change in qualification requirements may be included on an RA List in other circumstances, such as in cases in which a statutory change is enacted and the Treasury Department and the IRS anticipate that no guidance will be issued.

### III. CONTENT AND ORGANIZATION OF RA LIST

In general, an RA List includes statutory and administrative changes in qualification requirements that are first effective during the plan year in which the list is published. However, an RA List does not include guidance issued or legislation enacted after the list has been prepared<sup>1</sup> and also does not include:

- Statutory changes in qualification requirements for which the Treasury Department and the IRS expect to issue guidance (which would be included on an RA List issued in a future year);
- Changes in qualification requirements that permit (but do not require) optional plan provisions (in contrast to changes in the qualification requirements that cause existing plan provisions, which may include optional plan provisions previously adopted, to become disqualifying provisions);<sup>2</sup> or
- Changes in the tax laws affecting qualified plans that do not change the qualification requirements under section 401(a) (such as changes to the tax treatment of plan distributions, or changes to the funding requirements for qualified plans).

The RA List is divided into two parts. Part A covers changes in qualification requirements that generally would require an amendment to most plans or to most plans of the type affected by the change.

Part B includes changes in qualification requirements that the Treasury Department and the IRS anticipate will not require amendments in most plans, but might require an amendment because of an unusual plan provision in a particular plan. If a change affects a particular qualification requirement that most plans incorporate by reference, Part B would include the change because a particular plan might not incorporate the qualification requirement by reference and thus, might contain language inconsistent with the change. For example, if a defined benefit plan incorporates the limitation of section 436(d)(2) by reference to the statute or

regulations (or through the use of the sample amendment in Notice 2011–96, 2011–52 I.R.B. 915), no amendment to the plan would be required to comply with the changes made by section 2003 of the Highway Transportation and Funding Act of 2014. P.L. 113–159.

Annual, monthly, or other periodic changes to (1) the various dollar limits that are adjusted for cost of living increases as provided in section 415(d), etc., (2) the spot segment rates used to determine the applicable interest rate under section 417(e)(3), and (3) the applicable mortality table under section 417(e)(3), are treated as included on the RA List for the year in which such changes are effective even though they are not directly referenced on such RA List. The Treasury Department and the IRS anticipate that few plans have language that will need to be amended on account of these changes.

The fact that a change in a qualification requirement is included on the RA List does not mean that a plan must be amended as a result of that change. Each plan sponsor must determine whether a particular change in a qualification requirement requires an amendment to its plan.

### IV. 2016 REQUIRED AMENDMENTS LIST

Part A. *Changes in qualification requirements that generally would require an amendment to most plans or to most plans of the type affected by the change.*

- None

Part B. *Other changes in qualification requirements that may require an amendment.*

- *Collectively-bargained defined benefit plans:* Restrictions on accelerated distributions from underfunded single-employer plans in employer bankruptcy under § 436. (Highway and Transportation Funding Act of 2014, P.L. 113–159, § 2003)

<sup>1</sup>RA Lists may include changes in qualification requirements that were first effective in a prior year that were not included on a prior RA List under certain circumstances, such as changes in qualification requirements that were issued or enacted after the prior year's RA List was prepared.

<sup>2</sup>The remedial amendment period and plan amendment deadline for discretionary changes to the terms of a plan are governed by sections 5.05(2), 5.06(2), and 8.02 of Rev. Proc. 2016–37, and are not affected by the inclusion of a change in qualification requirements on an RA List.

## V. DRAFTING INFORMATION

The principal author of this notice is Anne Bolling of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Bolling at (202) 317-6799 (not a toll-free number).

*26 CFR 1.6049.00–00: Returns Relating to Payments of Interest (Also: 1.3406.07–00 Exceptions to Backup Withholding)*

## December 2016 Supplement to Rev. Proc. 2014–64, Implementation of Nonresident Alien Deposit Interest Regulations

### Rev. Proc. 2016–56

#### SECTION 1. PURPOSE

This revenue procedure supplements the listing in Section 3 of Revenue Procedure 2014–64, 2014–53 I.R.B. 1022, of the countries with respect to which the reporting requirement of §§ 1.6049–4(b)(5) and 1.6049–8(a) of the Income Tax Regulations applies, effective for interest paid on or after January 1, 2017.

This revenue procedure also supplements the listing in Section 4 of Revenue Procedure 2014–64, as previously supplemented by Rev. Proc. 2015–50, 2015–42 I.R.B. 583, and Rev. Proc. 2016–18, 2016–17 I.R.B. 635, of the countries with which the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have determined that it is appropriate to have an automatic exchange relationship with respect to the information collected under §§ 1.6049–4(b)(5) and 1.6049–8(a).

#### SECTION 2. BACKGROUND

Sections 1.6049–4(b)(5) and 1.6049–8(a), as revised by TD 9584, require the reporting of certain deposit interest paid to nonresident alien individuals on or after January 1, 2013. Rev. Proc. 2012–24, 2012–20 I.R.B. 913, was published contemporaneously with the publication of TD 9584. Section 3 of that revenue procedure identified those countries with

which the United States has in force an information exchange agreement, such that interest paid to residents of such countries must be reported by payors to the extent required under §§ 1.6049–4(b)(5) and 1.6049–8(a). Section 4 of that revenue procedure identified the countries with which the Treasury Department and the IRS had determined that it was appropriate to have an automatic exchange relationship with respect to the information collected under §§ 1.6049–4(b)(5) and 1.6049–8(a). Rev. Proc. 2012–24 was updated and superseded by Rev. Proc. 2014–64, Sections 3 and 4 of which contained updated lists of countries. Rev. Proc. 2014–64 was supplemented by Rev. Proc. 2015–50 and Rev. Proc. 2016–18, each of which added countries to the list in Section 4 of Rev. Proc. 2014–64. This revenue procedure supplements Rev. Proc. 2014–64 by adding Saint Lucia to the list of countries in Section 3 of Rev. Proc. 2014–64, and by adding Israel, Republic of Korea, and Saint Lucia to the list of countries in Section 4 of Rev. Proc. 2014–64.

#### SECTION 3. SUPPLEMENT TO SECTION 3 OF REV. PROC. 2014–64

Section 3 of Rev. Proc. 2014–64 is supplemented to read as follows:

The following are the countries with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of tax information within the meaning of section 6103(k)(4) pursuant to which the United States agrees to provide, as well as receive, information and under which the competent authority is the Secretary of the Treasury or his delegate:

Antigua & Barbuda  
Aruba  
Australia  
Austria  
Azerbaijan  
Bangladesh  
Barbados  
Belgium  
Bermuda  
Brazil  
British Virgin Islands  
Bulgaria  
Canada  
Cayman Islands

China  
Colombia  
Costa Rica  
Croatia  
Curacao  
Cyprus  
Czech Republic  
Denmark  
Dominica  
Dominican Republic  
Egypt  
Estonia  
Finland  
France  
Germany  
Gibraltar  
Greece  
Grenada  
Guernsey  
Guyana  
Honduras  
Hong Kong  
Hungary  
Iceland  
India  
Indonesia  
Ireland  
Isle of Man  
Israel  
Italy  
Jamaica  
Japan  
Jersey  
Kazakhstan  
Korea, Republic of  
Latvia  
Liechtenstein  
Lithuania  
Luxembourg  
Malta  
Marshall Islands  
Mauritius  
Mexico  
Monaco  
Morocco  
Netherlands  
Netherlands island territories: Bonaire, Saba, and St. Eustatius  
New Zealand  
Norway  
Pakistan  
Panama  
Peru  
Philippines  
Poland  
Portugal  
Romania

Russian Federation  
Saint Lucia  
Slovak Republic  
Slovenia  
South Africa  
Spain  
Sri Lanka  
St. Maarten (Dutch part)  
Sweden  
Switzerland  
Thailand  
Trinidad and Tobago  
Tunisia  
Turkey  
Ukraine  
United Kingdom  
Venezuela

**SECTION 4. SUPPLEMENT TO  
SECTION 4 OF REV. PROC. 2014-64**

Section 4 of Rev. Proc. 2014-64, as supplemented by Rev. Proc. 2015-50 and Rev. Proc. 2016-18, is further supplemented to read as follows:

The following list identifies the countries with which the automatic exchange of the information collected under §§ 1.6049-4(b)(5) and 1.6049-8 has been determined by the Treasury Department and the IRS to be appropriate:

Australia

Azerbaijan  
Brazil  
Canada  
Czech Republic  
Denmark  
Estonia  
Finland  
France  
Germany  
Gibraltar  
Guernsey  
Hungary  
Iceland  
India  
Ireland  
Isle of Man  
Israel  
Italy  
Jamaica  
Jersey  
Korea, Republic of  
Latvia  
Liechtenstein  
Lithuania  
Luxembourg  
Malta  
Mauritius  
Mexico  
Netherlands  
New Zealand  
Norway

Poland  
Saint Lucia  
Slovak Republic  
Slovenia  
South Africa  
Spain  
Sweden  
United Kingdom

**SECTION 5. EFFECT ON OTHER  
DOCUMENTS**

Rev. Proc. 2014-64, as supplemented by Rev. Proc. 2015-50 and Rev. Proc. 2016-18, is further supplemented.

**SECTION 6. EFFECTIVE DATE**

With respect to the additional country listed in Section 3, this revenue procedure is effective for interest paid on or after January 1, 2017.

**SECTION 7. DRAFTING  
INFORMATION**

The principal author of this revenue procedure is Jackie Bennett Manasterli of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure contact Ms. Manasterli at (202) 317-6941 (not a toll-free number).

## Part IV. Items of General Interest

### Liabilities Recognized as Recourse Partnership Liabilities Under Section 752

#### REG-122855-15

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking and notice of proposed rulemaking, including by cross reference to temporary regulations.

SUMMARY: This document contains proposed regulations that incorporate the text of related temporary regulations and withdraws a portion of a notice of proposed rulemaking (REG-119305-11) to the extent not adopted by final regulations. This document also contains new proposed regulations addressing when certain obligations to restore a deficit balance in a partner's capital account are disregarded under section 704 of the Internal Revenue Code (Code) and when partnership liabilities are treated as recourse liabilities under section 752. These regulations would affect partnerships and their partners.

DATES: The notice of proposed rulemaking under sections 707 and 752 that was published in the **Federal Register** on January 30, 2014 (REG-119305-11, 79 FR 4826), is partially withdrawn as of October 5, 2016. Written or electronic comments and requests for a public hearing must be received by January 3, 2017.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-122855-15), room 5203, 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-122855-15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal site at <http://www.regulations.gov> (indicate IRS and REG-122855-15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regula-

tions, Caroline E. Hay or Deane M. Burke, (202) 317-5279; concerning submissions of comments and requests for a public hearing, Regina L. Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION: In addition to these proposed regulations, the Treasury Department and the IRS are publishing in the Rules and Regulations section in this issue of the **Bulletin**: (1) final regulations under section 707 concerning disguised sales and under section 752 regarding the allocation of excess nonrecourse liabilities and (2) temporary regulations concerning a partner's share of partnership liabilities for purposes of section 707 and the treatment of certain payment obligations under section 752.

#### Paperwork Reduction Act

The collection of information related to these proposed regulations under section 752 is reported on Form 8275, Disclosure Statement, and has been reviewed in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and approved by the Office of Management and Budget under control number 1545-0889. Comments concerning the collection of information and the accuracy of estimated average annual burden and suggestions for reducing this burden should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the burden associated with this collection of information should be received by December 5, 2016.

The collection of information in these proposed regulations is in proposed § 1.752-2(b)(3)(ii)(D) (which cross references the requirement in § 1.752-2T(b)(3)(ii)(D)). This information is required by the IRS to ensure that section 752 of the Code and applicable regulations are properly applied for allocations of partnership liabilities. The respondents will be partners and partnerships.

An agency may not conduct or sponsor, and a person is not required to re-

spond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

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

#### Background

##### 1. Overview

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 704, 707, and 752 of the Code. On January 30, 2014, the Treasury Department and the IRS published a notice of proposed rulemaking in the **Federal Register** (REG-119305-11, 79 FR 4826) to amend the then existing regulations under section 707 relating to disguised sales of property to or by a partnership and under section 752 concerning the treatment of partnership liabilities (the 2014 Proposed Regulations). The 2014 Proposed Regulations provided certain technical rules intended to clarify the application of the disguised sale rules under section 707. The 2014 Proposed Regulations also contained rules regarding the sharing of partnership recourse and nonrecourse liabilities under section 752.

A public hearing on the 2014 Proposed Regulations was not requested or held, but the Treasury Department and the IRS received written comments. After consideration of, and in response to, the comments on the 2014 Proposed Regulations, the Treasury Department and the IRS are withdrawing the 2014 Proposed Regulations under § 1.752-2 and publishing new proposed regulations under § 1.752-2, as well as proposed regulations under section 704. Concurrently in this issue of the **Bulletin**, the Treasury Department and the IRS are also publishing final regulations that adopt, as modified, the 2014 Proposed Regulations under section 707 and § 1.752-3, and temporary regulations under sections 707 and 752.

## 2. Summary of Applicable Law

Section 752 separates partnership liabilities into two categories: recourse liabilities and nonrecourse liabilities. Section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss (EROL) for that liability under § 1.752-2. Section 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability under § 1.752-2.

A partner generally bears the EROL for a partnership liability if the partner or related person has an obligation to make a payment to any person within the meaning of § 1.752-2(b). For purposes of determining the extent to which a partner or related person has an obligation to make a payment, an obligation to restore a deficit capital account upon liquidation of the partnership under the section 704(b) regulations is taken into account. Further, for this purpose, § 1.752-2(b)(6) of the existing regulations presumes that partners and related persons who have payment obligations actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation (the satisfaction presumption). However, the satisfaction presumption is subject to an anti-abuse rule in § 1.752-2(j) pursuant to which a payment obligation of a partner or related person may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's EROL with respect to that obligation or create the appearance of the partner or related person bearing the EROL when the substance is otherwise. Under the existing rules, the satisfaction presumption is also subject to a disregarded entity net value requirement under § 1.752-2(k) pursuant to which, for purposes of determining the extent to which a partner bears the EROL for a partnership liability, a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date that is allocated to the partnership liability.

## 3. 2014 Proposed Regulations

As discussed in greater detail in the Summary of Comments and Explanation of Provisions section of this preamble, § 1.752-2 of the 2014 Proposed Regulations generally, among other things, (1) provided that a partner's or related person's obligation to make a payment with respect to a partnership liability (excluding those imposed by state law) would not be recognized for purposes of section 752 unless each recognition factor was satisfied; (2) applied the list of recognition factors to all payment obligations under § 1.752-2(b), including a partner's obligation to restore a deficit capital account upon liquidation of a partnership (deficit restoration obligations, or DROs) as provided under the section 704(b) regulations; and (3) provided generally that a payment obligation would be recognized to the extent of the net value of a partner or related person as of the allocation date.

After consideration of the comments received on the 2014 Proposed Regulations, the Treasury Department and the IRS are reconsidering the rules under section 752 regarding payment obligations that are recognized under § 1.752-2(b)(3), the satisfaction presumption under § 1.752-2(b)(6), the anti-abuse rule provided in § 1.752-2(j), and the net value requirement as provided in § 1.752-2(k). Accordingly, the Treasury Department and the IRS are withdrawing § 1.752-2 of the 2014 Proposed Regulations and publishing these new proposed regulations that would amend existing regulations under sections 704 and 752. These new provisions, and comments received on the 2014 Proposed Regulations that are pertinent to these new provisions, are discussed in the Summary of Comments and Explanation of Provisions section of the preamble that follows.

### 4. Final and Temporary Regulations Under Section 707 and Requests for Comments

As previously mentioned, the Treasury Department and the IRS are concurrently publishing temporary regulations under section 707 (concerning disguised sales) (the 707 Temporary Regulations) and section 752 (concerning recourse liabilities,

in particular bottom dollar payment obligations) (the 752 Temporary Regulations), and final regulations under section 707 and § 1.752-3. The temporary regulations are incorporated by cross reference in these proposed regulations. Notably, the 707 Temporary Regulations provide that, for disguised sale purposes, partners determine their share of any partnership liability in the manner in which excess nonrecourse liabilities are allocated under § 1.752-3(a)(3) (with certain limitations). Generally, a partner's share of the excess nonrecourse liability is determined in accordance with the partner's share of partnership profits taking into account all the facts and circumstances relating to the economic arrangement of the partners. The Treasury Department and the IRS recognize that taxpayers may require further guidance regarding reasonable methods for determining a partner's share of partnership profits under § 1.752-3(a)(3) for disguised sale purposes, especially given that a partner's share may change from year to year or differ with respect to different partnership assets and believe it may be appropriate to issue administrative guidance for this purpose. Accordingly, comments are requested regarding possible safe harbors and reasonable methods for determining a partner's share of profits, taking into account all of the relevant facts and circumstances relating to the economic arrangement of the partners. The preamble to the temporary regulations describes the provisions in greater detail. In addition, the final regulations under section 707 also include a request for comments concerning the exception for reimbursements of preformation capital expenditures under § 1.707-4(d), which is described in greater detail in the preamble to the final regulations.

## Summary of Comments and Explanation of Provisions

### 1. Rights of Reimbursement

Section 1.752-2(b)(1) provides that, except as otherwise provided in § 1.752-2, a partner bears the EROL for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that

liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or a person that is a related person to another partner. Section 1.752-2(b)(1) presumes that, in the constructive liquidation, the partnership has a value of zero with which to pay its liabilities. Under the 2014 Proposed Regulations, a partner would not bear the EROL under § 1.752-2(b)(1) if the partner or related person is entitled to a reimbursement from “any person.” Commenters noted that a reimbursement from “any person” would include a reimbursement from the partnership, which is contrary to the intent of the regulations under section 752. A right to be reimbursed by the partnership should be disregarded, as § 1.752-2(b)(1) presumes that the partnership would not be able to pay the liability or reimburse the partner. The Treasury Department and the IRS agree with the concerns expressed in the comments; therefore, these proposed regulations do not include the changes to § 1.752-2(b)(1) that were in the 2014 Proposed Regulations.

## *2. Arrangements Part of a Plan to Circumvent or Avoid an Obligation*

The 2014 Proposed Regulations provided that a partner’s or related person’s obligation to make a payment with respect to a partnership liability (excluding those imposed by state law) will not be recognized for purposes of section 752 unless: (1) the partner or related person is (A) required to maintain a commercially reasonable net worth throughout the term of the payment obligation or (B) subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration; (2) the partner or related person is required periodically to provide commercially reasonable documentation regarding the partner’s or related person’s financial condition; (3) the term of the payment obligation does not end prior to the term of the partnership liability; (4) the payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor; (5) the partner or related person received arm’s length consideration for

assuming the payment obligation; and (6) the obligation is not a bottom dollar guarantee or indemnity (recognition factors).

Commenters expressed concerns with the all-or-nothing approach in the 2014 Proposed Regulations. One commenter noted that a partner could cause an obligation to deliberately fail one of the recognition factors so as to cause a liability to be treated as nonrecourse if such characterization potentially would be beneficial to such partner, even if that partner did, in fact, bear the EROL. This commenter also noted that commercial arrangements rarely satisfy each and every one of the recognition factors and commercial practices tend to change over time, thereby rendering the recognition factors out of date. This commenter recommended that regulations instead provide a nonexclusive list of facts and circumstances containing as factors many of the items identified in the 2014 Proposed Regulations.

The Treasury Department and the IRS believe that the concerns expressed by the commenters are valid and thus propose to move the list of factors to an anti-abuse rule in § 1.752-2(j), other than the recognition factors concerning bottom dollar guarantees and indemnities, which are addressed in the 752 Temporary Regulations. Under the anti-abuse rule, factors are weighed to determine whether a payment obligation should be respected. The list of factors in the anti-abuse rule in these proposed regulations is nonexclusive, and the weight to be given to any particular factor depends on the particular case. Furthermore, the presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not a payment obligation is recognized under § 1.752-2(b).

In addition to comments addressing the recognition factor approach in the 2014 Proposed Regulations, the Treasury Department and the IRS received specific comments regarding the individual recognition factors. With respect to the first recognition factor regarding commercially reasonable net worth or restrictions on transfers, one commenter agreed that an obligor should have the wherewithal to make a payment to the extent required for the entire duration of its obligation, but believed that this concern is alleviated by the anti-abuse rule in the current regula-

tions under § 1.752-2(j). This commenter suggested that the anti-abuse rule in § 1.752-2(j) contain additional examples to illustrate abusive or problematic situations. Another commenter noted that the 2014 Proposed Regulations did not address the consequences if a partner or related person breaches its payment obligation under an agreement regarding net worth or restrictions on transfers and suggested that the regulations address such consequences in an anti-abuse rule (for example, a partner’s or related person’s payment obligation may be disregarded if it is determined that the creditor lacked the intent to enforce its rights under the agreement).

With respect to the first two recognition factors, commenters expressed concerns with the use of the terms “commercially reasonable” and “commercially reasonable documentation.” One commenter believed that these terms are vague and subjective and would require partnerships to make difficult judgments as to whether these recognition factors have been met prior to allocating any partnership liability. Another commenter noted that the “commercially reasonable documentation” recognition factor did not specify who should receive the documentation and that such documentation should be provided to the lender.

Moving the list of factors to an anti-abuse rule should alleviate some of the concerns expressed regarding both whether a payment obligor has the wherewithal to pay and the use of the term “commercially reasonable.” The proposed regulations also revise the first two factors to provide clarity by limiting the first factor to examine solely whether the partner or related person is subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions. In addition, the proposed regulations do not retain the subjective commercially reasonable net worth factor, but instead include a new factor that examines whether the payment obligation restricts the creditor from promptly pursuing payment following a default on the partnership liability or whether there are other arrangements that indicate a plan to delay collection.

The proposed regulations retain the use of the “commercially reasonable” standard, however, because different facts may require a different standard of whether contractual restrictions and documentation are “commercially reasonable” with respect to a particular industry, and the flexible nature of the term is helpful in informing partnerships and their partners that obligations should be consistent with what is customary in the marketplace. With respect to the second recognition factor regarding documentation, these proposed regulations also clarify that the factor examines whether commercially reasonable documentation was provided to the party that benefits from the payment obligation (for example, the creditor in the case of a guarantee or the indemnified party in the case of an indemnification arrangement).

Commenters also noted that certain recognition factors do not take into account industry specific practices. One commenter pointed out that the requirement that a payment obligation last throughout the full term of the partnership’s loan is contrary to commercial practice in some cases. In particular, the commenter noted that, in the real estate industry context, it is common for a construction loan to be guaranteed until the property reaches a required level of stabilization. This commenter did believe, however, that a payment obligation should be disregarded if the guarantor or other obligor has an unrestricted unilateral right to terminate the obligation at will, including immediately before the obligation becomes due and payable. Commenters also noted that the recognition factor that would require arm’s length consideration is not commercial, as a partner is often willing to enter into a guarantee or other payment obligation with respect to a partnership liability because the partner will benefit from the liability in the obligor’s capacity as a partner. The Treasury Department and the IRS agree with these recommendations; thus, these proposed regulations take into account industry practice with respect to terminations of payment obligations and do not include the arm’s length consideration factor.

A commenter also expressed concerns regarding the recognition factor that examines whether a primary obligor or any

other obligor with respect to the partnership liability is required to hold assets in an amount that exceeds the reasonable needs of the obligor. The commenter noted that partnership agreements often include restrictions on distributions before certain hurdles are satisfied for a variety of reasons, such as to protect the interests of preferred partners or for prudent business management. Another commenter agreed with the legal theory underpinning the recognition factor (to address fact patterns in which the taxpayer intended and acted to ensure the partnership maintained sufficient collateral to repay the creditor without exposing the obligor to meaningful liability) but suggested that commercially required or prudent reserves not be considered. Both commenters suggested that an example illustrating the restrictions that violate this factor would be helpful.

The commenters’ concerns should be largely addressed by making this recognition factor one of many examined under the anti-abuse rule that looks to whether there is a plan to circumvent or avoid the obligation. Under the anti-abuse rule, an obligor’s retention of assets for its reasonable foreseeable needs (such as for commercial or prudent business reasons) generally would not, on its own, indicate that there is a plan to circumvent or avoid the obligation.

Finally, the proposed regulations provide two additional factors that indicate when a plan to circumvent or avoid an obligation exists. The first provides that, in the case of a guarantee or similar arrangement, the terms of the liability would be substantially the same had the partner or related person not agreed to provide the guarantee. This factor indicates that the guarantee was not required by the lender, presumably because the partnership had sufficient assets to satisfy its obligation. The second additional factor examines whether the creditor or other party benefiting from the obligation received executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable time after, the creation of the obligation.

### 3. Deficit Restoration Obligations

The 2014 Proposed Regulations applied the list of recognition factors discussed in Section 2 of this Summary of Comments and Explanation of Provisions to all payment obligations under § 1.752-2(b), including a DRO, as provided under the section 704(b) regulations. Commenters explained that not all of the recognition factors could be satisfied with respect to a DRO. In addition, commenters suggested that the regulations under section 704(b) be amended to clarify that if a DRO is not given effect under section 752, it should not be given effect under section 704(b).

A DRO is an obligation to the partnership that is imposed by the partnership agreement. In contrast, a guarantee or indemnity is a contractual obligation outside the partnership agreement. As a result of this difference and based on the comments on the 2014 Proposed Regulations, the proposed regulations refine the list of factors applicable to DROs and clarify the interaction of section 752 with section 704 regarding DROs. Under § 1.704-1(b)(2)(ii)(c)(2) of the existing regulations, a partner’s DRO is not respected if the facts and circumstances indicate a plan to circumvent or avoid the partner’s DRO. These proposed regulations add a list of factors to § 1.704-1(b)(2)(ii)(c) that are similar to the factors in the proposed anti-abuse rule under § 1.752-2(j), but specific to DROs, to indicate when a plan to circumvent or avoid an obligation exists. Under the proposed regulations, the following factors indicate a plan to circumvent or avoid an obligation: (1) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner’s financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner’s interest in the partnership or when the partner’s capital account as provided in § 1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

Notwithstanding the proposed factors, the Treasury Department and the IRS have concerns with whether and to what extent it is appropriate to recognize DROs (and certain partner notes treated as DROs) as meaningful payment obligations. Many DROs are triggered only on the liquidation of a partnership. However, some partnerships are intended to have perpetual life and other partnerships can effectively cease operations but not actually liquidate; therefore, a partner's DRO may never be required to be satisfied. In addition, some DROs can be terminated or significantly reduced in a manner that may not be appropriate, and therefore, the DRO similarly may never be triggered. The Treasury Department and the IRS request comments on the extent to which such DROs should be recognized. In addition, certain partner notes are treated as DROs under § 1.704-1(b)(2)(ii)(c)(1) and (3) of these proposed regulations. The Treasury Department and the IRS also request comments concerning whether these obligations should continue to be treated as DROs.

#### 4. Exculpatory Liabilities

One commenter suggested that the 2014 Proposed Regulations would result in more liabilities being characterized as nonrecourse liabilities, in particular, so-called, "exculpatory liabilities," and urged the Treasury Department and the IRS to provide guidance with respect to such liabilities. An exculpatory liability is a liability that is recourse to an entity under state law and section 1001, but no partner bears the EROL within the meaning of section 752. Thus, the liability is treated as nonrecourse for section 752 purposes. The Treasury Department and the IRS are studying the treatment of exculpatory liabilities under sections 704 and 752 and agree that guidance is warranted in this area. However, the treatment of exculpatory liabilities is beyond the scope of these proposed regulations. The Treasury Department and the IRS seek additional comments regarding the proper treatment of an exculpatory liability under regulations under section 704(b) and the effect of such a liability's classification under section 1001. Further, the Treasury Department and the IRS request additional

comments addressing the allocation of an exculpatory liability among multiple assets and possible methods for calculating minimum gain with respect to such liability, such as the so-called "floating lien" approach (whereby all the assets in the entity, including cash, are considered to be subject to the exculpatory liability) or a specific allocation approach.

#### 5. Net Value

Section 1.752-2(b)(6) of the existing regulations provides that, for purposes of determining the extent to which a partner or related person has a payment obligation and the EROL, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. See § 1.752-2(b)(6), cross referencing § 1.752-2(j) and (k). Under the anti-abuse rule in § 1.752-2(j), a payment obligation is disregarded if there is a plan to circumvent or avoid such obligation. Section 1.752-2(k)(1) provides that, when determining the extent to which a partner bears the EROL for a partnership liability, a payment obligation of a business entity that is disregarded as an entity separate from its owner under section 856(i), section 1361(b)(3), or §§ 301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations (a disregarded entity) is taken into account only to the extent of the net value of the disregarded entity as of the allocation date that is allocated to the partnership liability. Section 1.752-2(k)(2)(i) provides, in part, that net value is the fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law less all obligations of the disregarded entity that do not constitute § 1.752-2(b)(1) payment obligations of the disregarded entity.

The 2014 Proposed Regulations provided that, in determining the extent to which a partner or related person other than an individual or a decedent's estate bears the EROL for a partnership liability other than a trade payable, a payment obligation is recognized only to the extent of the net value of the partner or related

person that, as of the allocation date, is allocated to the liability, as determined under § 1.752-2(k). The 2014 Proposed Regulations also provided that the partner must provide a statement concerning the net value of the payment obligor to the partnership. The preamble to the 2014 Proposed Regulations requested comments concerning whether the net value rule should also apply to individuals and estates and whether the regulations should consolidate these rules under § 1.752-2(k).

Commenters expressed concerns that an expansion of the net value rule would add considerable burden and expense to taxpayers and would likely lead to time consuming and costly disputes regarding valuations. Another commenter explained that taxpayers have often avoided the net value regulations (by not using disregarded entities) or have applied the regulations only when the disregarded entity has minimal or no assets.

Commenters suggested that if the net value rule is retained, § 1.752-2(k) should be extended to all partners and related persons other than individuals. One commenter expressed concerns that a partner who may be treated as bearing the EROL with respect to a partnership liability would have to provide information regarding the net value of the payment obligor, which is unnecessarily intrusive. Another commenter believed that if the rules requiring net value were extended to all partners in partnerships, the attempt to achieve more realistic substance would be accompanied by a corresponding increase in the potential for manipulation.

The Treasury Department and the IRS remain concerned with ensuring that a partner or related person only be presumed to satisfy its payment obligation to the extent that such partner or related person would be able to pay on the obligation. After consideration of the comments, however, the Treasury Department and the IRS agree that expanding the application of the net value rules under § 1.752-2(k) may lead to more litigation and may unduly burden taxpayers. Furthermore, net value as provided in § 1.752-2(k) may not accurately take into account the future earnings of a business entity, which normally factor into lending decisions. Therefore, the Treasury Department and the IRS

propose to remove § 1.752-2(k) and instead create a new presumption under the anti-abuse rule in § 1.752-2(j). Under the presumption in the proposed regulations, evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. A payment obligor includes disregarded entities (including grantor trusts). These proposed regulations also add an example to illustrate the application of the anti-abuse rule when the payment obligor is an underfunded entity. Under these proposed regulations, § 1.752-2(b)(6) continues to presume that payment obligations with respect to a partnership liability will be satisfied unless evidence of a plan to circumvent or avoid the obligation exists as determined under § 1.752-2(j). If evidence of a plan to circumvent or avoid the obligation exists or is deemed to exist, the obligation is not recognized under § 1.752-2(b) and therefore the partnership liability is treated as a nonrecourse liability under § 1.752-1(a)(2).

#### Proposed Applicability Dates

The amendments to § 1.704-1 are proposed to apply on or after the date these regulations are published as final regulations in the **Federal Register**. The amendments to § 1.752-2 are proposed to apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date these regulations are published as final regulations in the **Federal Register**. Partnerships and their partners may rely on these proposed regulations prior to the date they are published as final regulations in the **Federal Register**. However, the rules in § 1.752-2(k) still apply to disregarded entities until the proposed regulations are published as final regulations in the **Federal Register**.

Some commenters were concerned that the 2014 Proposed Regulations “delinked” the regulations under sections 704 and 752 concerning DROs, that is, that a DRO may somehow still be recognized under section 704 despite not meeting the requirements to be recognized as a payment

obligation under section 752. DROs are subject to the bottom dollar payment obligation rules in the 752 Temporary Regulations, but the rules in these proposed regulations concerning DROs will not be effective prior to the date they are published as final regulations in the **Federal Register**. However, these proposed regulations allow partnerships and their partners to rely on the proposed regulations, which should address this concern.

#### Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal in that it requires partnerships (including partnerships that may be small entities) to provide information they already maintain or can easily obtain to the IRS. Moreover, it should take a partnership no more than 2 hours to satisfy the information requirement in these regulations. Accordingly, a Regulatory Flexibility Analysis under 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 comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available for public in-

spection and copying at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing will be scheduled if requested in writing by a person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

#### Drafting Information

The principal authors of these regulations are Caroline E. Hay and Deane M. Burke of the Office of the Associate Chief Counsel (Passthroughs & Special Industries), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

#### Withdrawal of Proposed Regulations

Accordingly, under the authority of 26 U.S.C. 7805, § 1.752-2 of the notice of proposed rulemaking (REG-119305-11) that was published in the **Federal Register** on January 30, 2014 (79 FR 4826) 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 \* \* \*

Sections 1.707-2 through 1.707-9 also issued under 26 U.S.C. 707(a)(2)(B).

Par. 2. Section 1.704-1 is amended by:

1. Adding two sentences to the end of paragraph (b)(1)(ii)(a).

2. Adding a sentence to the end of paragraph (b)(2)(ii)(b)(3) introductory text.

3. Removing the undesignated paragraph following paragraph (b)(2)(ii)(b)(3).

4. Adding paragraphs (b)(2)(ii)(b)(4) through (7).

5. Revising paragraph (b)(2)(ii)(c).

The additions and revisions read as follows:

§ 1.704-1 Partner's distributive share.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(a) \* \* \* Furthermore, the last sentence of paragraph (b)(2)(ii)(b)(3) of this section and paragraphs (b)(2)(ii)(b)(4) through (7) and (b)(2)(ii)(c) of this section apply on or after the date these regulations are published as final regulations in the **Federal Register**. However, taxpayers may rely on the last sentence of paragraph (b)(2)(ii)(b)(3) of this section and paragraphs (b)(2)(ii)(b)(4) through (7) and (b)(2)(ii)(c) of this section on or after October 5, 2016 and before the date these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

(2) \* \* \*

(ii) \* \* \*

(b) \* \* \*

(3) \* \* \* Notwithstanding the partnership agreement, an obligation to restore a deficit balance in a partner's capital account, including an obligation described in paragraph (b)(2)(ii)(c)(1) of this section, will not be respected for purposes of this section to the extent the obligation is disregarded under paragraph (b)(2)(ii)(c)(4) of this section.

(4) For purposes of paragraphs (b)(2)(ii)(b)(1) through (3) of this section, a partnership taxable year shall be determined without regard to section 706(c)(2)(A).

(5) The requirements in paragraphs (b)(2)(ii)(b)(2) and (3) of this section are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.

(6) The requirement in paragraph (b)(2)(ii)(b)(2) of this section is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in the requirement in paragraph (b)(2)(ii)(b)(2) of this section in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances.

(7) See examples (1)(i) and (ii), (4)(i), (8)(i), and (16)(i) of paragraph (b)(5) of this section for issues concerning paragraph (b)(2)(ii)(b) of this section.

(c) *Obligation to restore deficit—(1) Other arrangements treated as obligations to restore deficits.* If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section and subject to paragraph (b)(2)(ii)(c)(2) of this section) to the extent of—

(A) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(B) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker).

(2) *Satisfaction requirement.* For purposes of paragraph (b)(2)(ii)(c)(1) of this section, a promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90

days after the date of such liquidation). If a promissory note referred to in paragraph (b)(2)(ii)(c)(1) of this section is negotiable, a partner will be considered required to satisfy such note within the time period specified in this paragraph (b)(2)(ii)(c)(2) if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(d)(2) of this section. See examples (1)(ix) and (x) of paragraph (b)(5) of this section.

(3) *Related party notes.* For purposes of paragraph (b)(2) of this section, if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988, and the maker of such note is a person related to such partner (within the meaning of § 1.752-4(b)(1)), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(4) *Obligations disregarded—(A) General rule.* A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section) to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under § 1.752-2(b)(3) or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. See paragraphs (b)(2)(ii)(f), (b)(2)(ii)(h), and (b)(4)(vi) of this section for other rules regarding such obligation. To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section), the obligation is disregarded and paragraph (b)(2) of this section and § 1.752-2 are applied as if the obligation did not exist.

(B) *Factors indicating plan to circumvent or avoid obligation.* In the case of an obligation to restore a deficit balance in a partner's capital account upon liquidation of a partnership, paragraphs (b)(2)(ii)(c)(4)(B)(i) through (iv) of this section

provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation. For purposes of making determinations under this paragraph (b)(2)(ii)(c)(4), the weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The following factors are taken into consideration for purposes of this paragraph (b)(2):

(i) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(ii) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

(iii) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in § 1.704-1(b)(2)(iv) is negative.

(iv) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.

\* \* \* \* \*

Par. 3. Section 1.707-0 is amended by revising the entries for § 1.707-5(a)(2)(i) and (ii) to read as follows:

§ 1.707-0 Table of contents.

\* \* \* \* \*

§ 1.707-5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) \* \* \*

(2) \* \* \*

(i) In general.

(ii) Partner's share of § 1.752-7 liability.

\* \* \* \* \*

Par. 4. Section 1.707-5 is amended by revising paragraph (a)(2) and *Examples 2, 3, 7, and 8* of paragraph (f) to read as follows:

§ 1.707-5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) \* \* \*

(2) [The text of proposed § 1.707-5(a)(2) is the same as the text of § 1.707-5T(a)(2) published elsewhere in this issue of the **Bulletin**].

\* \* \* \* \*

(f) \* \* \*

*Example 2.* [The text of proposed § 1.707-5(f) *Example 2* is the same as the text of § 1.707-5T(f) *Example 2* published elsewhere in this issue of the **Bulletin**].

*Example 3.* [The text of proposed § 1.707-5(f) *Example 3* is the same as the text of § 1.707-5T(f) *Example 3* published elsewhere in this issue of the **Bulletin**].

\* \* \* \* \*

*Example 7.* [The text of proposed § 1.707-5(f) *Example 7* is the same as the text of § 1.707-5T(f) *Example 7* published elsewhere in this issue of the **Bulletin**].

*Example 8.* [The text of proposed § 1.707-5(f) *Example 8* is the same as the text of § 1.707-5T(f) *Example 8* published elsewhere in this issue of the **Bulletin**].

\* \* \* \* \*

Par. 5. Section 1.707-9 is amended by adding paragraph (a)(5) to read as follows:

§ 1.707-9 Effective dates and transitional rules.

(a) \* \* \*

(5) [The text of proposed § 1.707-9(a)(5) is the same as the text of § 1.707-9T(a)(5) published elsewhere in this issue of the **Bulletin**].

\* \* \* \* \*

Par. 6. Section 1.752-0 is amended by:

1. Adding entries for § 1.752-2(b)(3)(i) and (ii), (b)(3)(ii)(A) and (B), (b)(3)(ii)(C), (b)(3)(ii)(C)(I) through (3), (b)(3)(ii)(D), and (b)(3)(iii).

2. Adding entries for § 1.752-2(j)(2)(i) and (ii).

3. Adding entries for § 1.752-2(j)(3)(i) through (iii).

4. Revising the entries for § 1.752-2(j)(3) and (4).

5. Adding an entry for § 1.752-2(k).

The revisions and additions read as follows:

§ 1.752-0 Table of contents.

\* \* \* \* \*

§ 1.752-2 Partner's share of recourse liabilities.

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(i) In general.

(ii) Special rules for bottom dollar payment obligations.

(A) In general.

(B) Exception.

(C) Definition of bottom dollar payment obligation.

(I) In general.

(2) Exceptions.

(3) Benefited party defined.

(D) Disclosure of bottom dollar payment obligations.

(iii) Special rule for indemnities and reimbursement agreements.

\* \* \* \* \*

(j) \* \* \*

(2) \* \* \*

(i) In general.

(ii) Economic risk of loss.

(3) Plan to circumvent or avoid an obligation.

(i) General rule.

(ii) Factors indicating plan to circumvent or avoid an obligation.

(iii) Deemed plan to circumvent or avoid an obligation.

(4) Examples.

(k) Effective/applicability dates.

\* \* \* \* \*

Par. 7. Section 1.752-2 is amended by:

1. Revising the last sentence of paragraph (a).

2. Revising paragraph (b)(3) and the last sentence of paragraph (b)(6).

3. Adding a sentence to the end of paragraph (f) introductory text and adding *Examples 10 and 11* to paragraph (f).

4. Revising paragraphs (j)(2) and (3).

5. Adding paragraph (j)(4).

6. Removing paragraph (k).

7. Redesignating paragraph (l) as paragraph (k) and revising it.

The revisions and additions read as follows:

§ 1.752-2 Partner's share of recourse liabilities.

(a) \* \* \* The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (j) of this section.

(b) \* \* \*

(3) [The text of proposed § 1.752-2(b)(3) is the same as the text of § 1.752-2T(b)(3) published elsewhere in this issue of the **Bulletin**].

\* \* \* \* \*

(6) \* \* \* See paragraph (j) of this section.

\* \* \* \* \*

(f) *Examples.* \* \* \* Unless otherwise provided, for purposes of the following examples, assume that any obligation of a partner or related person to make a payment is recognized under paragraph (b)(3) of this section.

\* \* \* \* \*

*Example 10.* [The text of proposed § 1.752-2(f) *Example 10* is the same as the text of § 1.752-2T(f) *Example 10* published elsewhere in this issue of the **Bulletin**].

*Example 11.* [The text of proposed § 1.752-2(f) *Example 11* is the same as the text of § 1.752-2T(f) *Example 11* published elsewhere in this issue of the **Bulletin**].

\* \* \* \* \*

(j) \* \* \*

(2) [The text of proposed § 1.752-2(j)(2) is the same as the text of § 1.752-2T(j)(2) published elsewhere in this issue of the **Bulletin**].

(3) *Plan to circumvent or avoid an obligation—(i) General rule.* An obligation of a partner or related person to make a payment is not recognized under paragraph (b) of this section if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

(ii) *Factors indicating plan to circumvent or avoid an obligation.* In the case of a payment obligation, other than an obligation to restore a deficit capital account upon liquidation of a partnership, paragraphs (j)(3)(ii)(A) through (G) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation. The presence or absence of a factor is based on all

of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. For purposes of making determinations under this paragraph (j)(3), the weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized under paragraph (b) of this section.

(A) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

(B) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party.

(C) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the

reasonable foreseeable needs of such obligor.

(E) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(F) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(G) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

(iii) *Deemed plan to circumvent or avoid an obligation.* Evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. For purposes of this section, a payment obligor includes an entity disregarded as an entity separate from its owner under section 856(i), section 1361(b)(3), or §§ 301.7701-1 through 301.7701-3 of this chapter (a disregarded entity), and a trust to which subpart E of part I of subchapter J of chapter 1 of the Code applies.

(4) *Examples.* The following examples illustrate the principles of paragraph (j) of this section.

*Example 1. Gratuitous guarantee.* (i) In 2016, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2016, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2016. In 2018, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under paragraph (j)(3) of this section, A's 2018 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circum-

vent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: (1) the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; (2) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (3) in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and (4) the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A's guarantee is not recognized under paragraph (b) of this section. As a result, LLC's liability continues to be treated as nonrecourse.

*Example 2. Underfunded disregarded entity payment obligor.* (i) In 2016, A forms a wholly owned domestic limited liability company, LLC, with a contribution of \$100,000. A has no liability for LLC's debts, and LLC has no enforceable right to a contribution from A. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC is a treated for federal tax purposes as a disregarded entity. Also in 2016, LLC contributes \$100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes \$100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to restore any deficit in its capital account. On January 1, 2017, LP borrows \$300,000 from a bank and uses \$600,000 to purchase nondepreciable property. The \$300,000 is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its \$300,000 debt during 2017. LP has a net taxable loss in 2017, and, under §§ 1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the \$300,000 debt at the end of its taxable year, December 31, 2017. As of that date, LLC holds no assets other than its interest in LP.

(ii) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the \$300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (j)(3)(iii) of this section is applied to the LLC and not to A. LLC has no assets with which to pay if the payment obligation becomes due and payable. As such, evidence of a plan to circumvent or avoid the obligation is deemed to exist and, pursuant to paragraph (j)(3)(i) of this section, LLC's obligation to restore its deficit capital account is not recognized under paragraph (b) of this section. As a result, LP's \$300,000 debt is characterized as nonrecourse under § 1.752-1(a)(2) and is allocated among A, B, and C under § 1.752-3.

(k) *Effective/applicability dates.* (1) Paragraph (h)(3) of this section applies to

liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. The rules applicable to liabilities incurred or assumed (or pursuant to a written binding contract in effect) prior to October 11, 2006, are contained in § 1.752-2 in effect prior to October 11, 2006, (see 26 CFR part 1 revised as of April 1, 2006). The last sentence of paragraphs (a), (b)(6), and (f) of this section and paragraphs (j)(3) and (4) of this section apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date these regulations are published as final regulations in the **Federal Register**, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. Taxpayers may rely on these regulations for the period between October 5, 2016 and the date these regulations are published as final regulations in the **Federal Register**.

(2) [The text of proposed § 1.752-2(k)(2) is the same as the text of § 1.752-2T(l)(2) published elsewhere in this issue of the **Bulletin**].

(3) [The text of proposed § 1.752-2(k)(3) is the same as the text of § 1.752-2T(l)(3) published elsewhere in this issue of the **Bulletin**].

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

(Filed by the Office of the Federal Register on October 4, 2016, 8:45 a.m., and published in the issue of the Federal Register for October 5, 2016, 81 F.R. 69301)

## Covered Asset Acquisitions REG 129128-14

AGENCY: Internal Revenue Service (IRS), Treasury.

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

**SUMMARY:** This document contains proposed Income Tax Regulations under section 901(m) of the Internal Revenue Code (Code) with respect to transactions that generally are treated as asset acquisitions for U.S. income tax purposes and either are treated as stock acquisitions or are disregarded for foreign income tax purposes. In the Rules and Regulations section of this issue of the **Bulletin**, temporary regulations are being issued under section 901(m) (the temporary regulations), the text of which serves as the text of a portion of these proposed regulations. These regulations are necessary to provide guidance on applying section 901(m). These regulations affect taxpayers claiming foreign tax credits.

**DATES:** Comments and requests for a public hearing must be received by March 7, 2017.

**ADDRESSES:** Send submissions to CC: PA:LPD:PR (REG-129128-14), 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-129128-14), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20044, or sent electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-129128-14).

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Jeffrey L. Parry, (202) 317-6936; concerning submissions of comments, Regina Johnson, (202) 317-6901 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

### Background

#### I. Section 901(m)

Section 212 of the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010 (Public Law 111-226), added section 901(m) to the Code. Section 901(m)(1) provides that, in the case of a covered asset acquisition (CAA), the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to

relevant foreign assets (RFAs) will not be taken into account in determining the foreign tax credit allowed under section 901(a), and, in the case of foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), will not be taken into account for purposes of section 902 or 960. Instead, the disqualified portion of any foreign income tax (the disqualified tax amount) is permitted as a deduction. See section 901(m)(6).

Under section 901(m)(2), a CAA is (i) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies; (ii) any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as the acquisition of stock of a corporation (or is disregarded) for purposes of a foreign income tax; (iii) any acquisition of an interest in a partnership that has an election in effect under section 754; and (iv) to the extent provided by the Secretary, any other similar transaction. The Joint Committee on Taxation's technical explanation of EJMAA states that it is anticipated that the Secretary will issue regulations identifying other similar transactions that result in an increase to the basis of assets for U.S. income tax purposes without a corresponding increase for foreign income tax purposes. Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, at 14 (Aug. 10, 2010) (JCT Explanation).

Section 901(m)(3)(A) provides that the term "disqualified portion" means, with respect to any CAA, for any taxable year, the ratio (expressed as a percentage) of (i) the aggregate basis differences (but not below zero) allocable to such taxable year with respect to all RFAs; divided by (ii) the income on which the foreign income tax referenced in section 901(m)(1) is determined. If the taxpayer fails to substantiate the income on which the foreign income tax is determined to the satisfaction of the Secretary, such income will be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to the taxpayer's income in the relevant jurisdiction. The JCT Explanation states that for this

purpose the income on which the foreign income tax is determined is the income as determined under the law of the relevant jurisdiction. See JCT Explanation at 14.

Section 901(m)(3)(B)(i) provides the general rule that the basis difference with respect to any RFA will be allocated to taxable years using the applicable cost recovery method for U.S. income tax purposes. Section 901(m)(3)(B)(ii) provides that, except as otherwise provided by the Secretary, if there is a disposition of an RFA, the basis difference allocated to the taxable year of the disposition will be the excess of the basis difference of such asset over the aggregate basis difference of such asset that has been allocated to all prior taxable years. The statute further provides that no basis difference with respect to such asset will be allocated to any taxable year thereafter.

Section 901(m)(3)(C)(i) provides that basis difference means, with respect to any RFA, the excess of: (i) the adjusted basis of such asset immediately after the CAA, over (ii) the adjusted basis of such asset immediately before the CAA. If the adjusted basis of an RFA immediately before the CAA exceeds the adjusted basis of the RFA immediately after the CAA (that is, where the adjusted basis of an asset with a built-in loss is reduced in a CAA), such excess is taken into account as a basis difference of a negative amount. See section 901(m)(3)(C)(ii).

The JCT Explanation states that, for purposes of determining basis difference, it is the tax basis for U.S. income tax purposes that is relevant and not the tax basis as determined under the law of the relevant jurisdiction. See JCT Explanation at 14. However, the JCT Explanation further states that it is anticipated that the Secretary will issue regulations identifying those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the CAA, it may be acceptable to use foreign basis or another reasonable method. *Id.*

Section 901(m)(4) provides that an RFA means, with respect to a CAA, any asset (including goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the for-

ign income tax referenced in section 901(m)(1).

Section 901(m)(7) provides that the Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 901(m), including to exempt from its application certain CAAs and RFAs with respect to which the basis difference is *de minimis*. The JCT Explanation states that regulations may also exclude from the application of section 901(m) CAAs that are not taxable for U.S. income tax purposes, or in which the basis of the RFAs is also increased for purposes of the law of the relevant foreign jurisdiction. See JCT Explanation at 16.

Section 901(m) generally applies to CAAs occurring after December 31, 2010. Section 901(m), however, does not apply to any CAA with respect to which the transferor and transferee are not related if the acquisition is made pursuant to a written agreement that was binding on January 1, 2011, and at all times thereafter; described in a ruling request submitted to the IRS on or before July 29, 2010; or described on or before January 1, 2011, in a public announcement or in a filing with the Securities and Exchange Commission. See EJMAA, section 212(b).

## II. Notices 2014-44 and 2014-45

The Department of the Treasury (Treasury Department) and the IRS issued Notice 2014-44 (2014-32 I.R.B. 270 (July 21, 2014)) and Notice 2014-45 (2014-34 I.R.B. 388 (July 29, 2014)), announcing the intent to issue regulations addressing the application of section 901(m) to dispositions of RFAs following CAAs and to CAAs described in section 901(m)(2)(C) (regarding section 754 elections). In addition, the notices announced the intent to issue regulations providing successor rules for the continued application of section 901(m) after subsequent transfers of RFAs with remaining basis difference. The temporary regulations issued in the Rules and Regulations section of this issue of the **Bulletin** provide the rules described in those Notices.

## Explanation of Provisions

### I. Overview

These proposed regulations provide rules for computing the disqualified portion of foreign income taxes under section 901(m). Proposed § 1.901(m)-1 provides definitions that apply for purposes of the proposed regulations. Proposed § 1.901(m)-2 identifies the transactions that are CAAs, including additional categories of transactions that are identified as CAAs pursuant to the authority granted in section 901(m)(2)(D), and provides rules for identifying assets that are RFAs with respect to a CAA. Proposed § 1.901(m)-3 provides rules for computing the disqualified portion of foreign income taxes, describes the treatment under section 901(m)(1) of the disqualified portion, and provides rules for determining whether and to what extent basis difference that is assigned to a given taxable year is carried over to subsequent taxable years. Proposed § 1.901(m)-4 provides rules for determining the basis difference with respect to an RFA, including an election to use foreign basis for purposes of this determination. Proposed § 1.901(m)-5 provides rules for taking into account basis difference under an applicable cost recovery method or as a result of a disposition of an RFA, rules for allocating that basis difference, when necessary, to one or more persons subject to section 901(m), and rules for assigning that basis difference to a U.S. taxable year. Proposed § 1.901(m)-6 provides successor rules for applying section 901(m) to subsequent transfers of RFAs that have basis difference that has not yet been fully taken into account, as well as for transferring an aggregate basis difference carryover of a person subject to section 901(m) either to another aggregate basis difference carryover account of such person or to another person subject to section 901(m). Proposed § 1.901(m)-7 provides de minimis rules under which certain basis differences are not taken into account under section 901(m). Proposed § 1.901(m)-8 provides guidance on the application of section 901(m) to pre-1987 foreign income taxes and anti-abuse rules relating to built-in loss assets.

### II. Relevance of the Terms Section 901(m) Payor, Foreign Payor, RFA Owner (U.S.), and RFA Owner (foreign)

As provided under proposed § 1.901(m)-1, a section 901(m) payor is a person that is eligible to claim the foreign tax credit allowed under section 901(a), regardless of whether the person chooses to claim the foreign tax credit, as well as a section 902 corporation. Therefore, a section 901(m) payor is the person required to compute a disqualified tax amount when section 901(m) applies. The foreign payor is the individual or entity (including a disregarded entity) subject to a foreign income tax. The RFA owner (U.S.) is the person that owns one or more RFAs for U.S. income tax purposes and therefore is required to report, or otherwise track, items of income, deduction, gain, or loss attributable to the RFAs for purposes of computing the U.S. taxable income of the RFA owner (U.S.). Similarly, the RFA owner (foreign) is the individual or entity (including a disregarded entity) that owns one or more RFAs for purposes of a foreign income tax and that therefore generally would report, or otherwise track, items of income, deduction, gain, or loss attributable to the RFAs for purposes of determining income reported on a foreign income tax return.

The section 901(m) payor may also be the foreign payor, the RFA owner (U.S.), or the RFA owner (foreign), or any combination thereof; alternatively, the section 901(m) payor may not be any of them depending upon the application of the entity classification rules for U.S. income tax purposes. Further, the foreign payor and the RFA owner (foreign) may or may not be the same person for purposes of a foreign income tax depending upon whether the RFA owner (foreign) is a fiscally transparent entity for purposes of the foreign income tax. For example, if a foreign corporation, which is a section 902 corporation, owns RFAs and is the entity that is subject to a foreign income tax under the relevant foreign law, the foreign corporation is the section 901(m) payor, foreign payor, RFA owner (U.S.), and RFA owner (foreign). As another example, if two U.S. corporations each own a 50 percent interest in a partnership and the partnership owns a disregarded entity

that is subject to a foreign income tax and that, for purposes of the foreign income tax, owns one or more RFAs, the corporate partners are each a section 901(m) payor, the disregarded entity is the foreign payor and the RFA owner (foreign), and the partnership is the RFA owner (U.S.).

Finally, because the computation of a section 901(m) payor's disqualified tax amount is based on items determined at the level of the foreign payor, the RFA owner (U.S.), and the RFA owner (foreign), the regulations provide rules for allocating those items when the section 901(m) payor is not the foreign payor, the RFA owner (U.S.), or the RFA owner (foreign), or any combination thereof.

### III. CAAs and RFAs

#### A. CAAs

Proposed § 1.901(m)-2(b) identifies six categories of transactions that constitute CAAs, three of which are specified in the statute (incorporated by cross reference to the temporary regulations) and three of which are additional categories of transactions that are identified as CAAs pursuant to the authority granted under section 901(m)(2)(D). In addition, for transactions that occurred on or after January 1, 2011, and before the general applicability date of the temporary regulations (referred to as the "transition period" in the preamble to the temporary regulations and in this preamble), proposed § 1.901(m)-2(d) (incorporated by cross reference to the temporary regulations) defines CAAs by reference to the statutory definition under section 901(m)(2). Transactions are CAAs regardless of whether any gain, income, loss, or deduction realized in connection with the transaction is taken into account for U.S. income tax purposes. However, basis difference resulting from a CAA may not be taken into account under section 901(m) pursuant to de minimis rules in proposed § 1.901(m)-7.

Proposed § 1.901(m)-2(b)(1) through (4) describes four specific types of transactions that are generally expected to result in an increase in the basis of assets for U.S. income tax purposes without a corresponding increase in basis for foreign income tax purposes. This is because

these transactions generally are treated as an acquisition of assets for U.S. income tax purposes and either are treated as an acquisition of stock or of a partnership interest or are disregarded for foreign income tax purposes. The other two categories of transactions described in proposed § 1.901(m)-2(b)(5) and (6), which involve an acquisition of assets for both U.S. and foreign income tax purposes, are CAAs only if the transaction results in an increase in the basis of an asset for U.S. income tax purposes but not for foreign income tax purposes. Such transactions may include, for example, an acquisition of assets that is structured to avoid the application of the Code's corporate non-recognition provisions, such as section 332, 351, or 361, while still qualifying for nonrecognition treatment for foreign income tax purposes.

#### B. RFAs

Proposed § 1.901(m)-2(c)(1) incorporates by cross reference to the temporary regulations the general definition of an RFA, which provides that an RFA means, with respect to a foreign income tax and a CAA, any asset (including goodwill, going concern value, or other intangible) subject to the CAA that is relevant in determining foreign income for purposes of the foreign income tax. In addition, for CAAs that occurred during the transition period, proposed § 1.901(m)-2(d) (incorporated by cross reference to the temporary regulations) defines RFAs by reference to the statutory definition under section 901(m)(4).

Proposed § 1.901(m)-2(c)(2) generally provides that an asset is relevant in determining foreign income if income, deduction, gain, or loss attributable to such asset is or would be taken into account in determining foreign income immediately after the CAA. Proposed § 1.901(m)-2(c)(3) provides, however, that, after a CAA, an asset will become an RFA with respect to another foreign income tax if, pursuant to a plan or series of related transactions that have a principal purpose of avoiding the application of section 901(m), an asset that is not relevant in determining foreign income for purposes of that foreign income tax immediately after the CAA later becomes relevant in

determining such foreign income. A principal purpose of avoiding section 901(m) will be deemed to exist if income, deduction, gain, or loss attributable to the asset is taken into account in determining such foreign income within the one-year period following the CAA.

#### IV. *Disqualified Tax Amount and Aggregate Basis Difference Carryover*

##### A. *Disqualified tax amount*

Proposed § 1.901(m)-3 sets forth the rules for computing the disqualified portion of foreign income taxes (referred to in the regulations as the “disqualified tax amount”). Proposed § 1.901(m)-3 also sets forth the treatment under section 901(m)(1) of the disqualified tax amount and provides rules for determining whether and to what extent basis difference that is assigned to a given U.S. taxable year is carried over to subsequent U.S. taxable years (referred to in the regulations as “aggregate basis difference carryover”).

In general, a disqualified tax amount is computed separately for each foreign tax return that takes into account income, gain, deduction, or loss from one or more RFAs in computing the foreign taxable income and for each section 901(m) payor that pays or accrues, or that is considered to pay or accrue, a portion of the foreign income taxes reflected on the foreign tax return. Furthermore, if the foreign income taxes relate to more than one separate category described in § 1.904-4(m) (including section 904(d) categories), a separate disqualified tax amount computation is done for each such separate category. Members of a U.S. affiliated group of corporations (as defined in section 1504) that file a consolidated return are each treated as a separate section 901(m) payor; therefore, disqualified tax amounts are computed at the member-level.

The proposed regulations refer to the total taxable income (or loss) that is computed under foreign law for a foreign taxable year and reflected on a foreign tax return as “foreign income” and the total amount of tax reflected on a foreign tax return as a “foreign income tax amount.” Thus, foreign income does not include income that is exempt from the foreign

income tax. The proposed regulations use the term “foreign country creditable taxes” (or “FCCTs”) to refer to any foreign income taxes imposed by another foreign country or possession of the United States that were allowed under the relevant foreign law as a credit to reduce the foreign income tax amount and for which a credit is allowed under section 901 or 903. In addition, the proposed regulations define “foreign income tax” (by cross reference to the temporary regulations) to mean any income, war profits, or excess profits tax for which a credit is allowable under section 901 or 903, other than any withholding tax determined on a gross basis as described in section 901(k)(1)(B).

The foreign income, foreign income tax amount, and any FCCTs are determined at the foreign-payor level. If the foreign payor is not a section 901(m) payor, current law provides rules for determining the person that is considered to pay or accrue a foreign income tax amount for purposes of the foreign tax credit (see, for example, §§ 1.702-1(a)(6) and 1.901-2(f)). Those rules are not changed by these proposed regulations and therefore apply for purposes of determining the extent to which a foreign income tax amount is paid or accrued by, or considered paid or accrued by, a section 901(m) payor for purposes of section 901(m).

Proposed § 1.901(m)-3(b) sets forth the treatment of the disqualified tax amount and the computation of the disqualified tax amount. Pursuant to section 901(m)(1) and proposed § 1.901(m)-3(b)(1), the disqualified tax amount is not taken into account for purposes of determining foreign tax credits under section 901, 902, or 960. A section 901(m) payor must compute a disqualified tax amount for any U.S. taxable year for which it is assigned a portion of the basis difference with respect to one or more RFAs.

The disqualified tax amount is the lesser of the tentative disqualified tax amount and the foreign income tax amount paid or accrued by, or considered paid or accrued by, a section 901(m) payor. The tentative disqualified tax amount is determined using a modified version of the formula provided in section 901(m)(3). To determine the tentative dis-

qualified tax amount, the foreign income tax amount paid or accrued by, or considered paid or accrued by, the section 901(m) payor for its U.S. taxable year (multiplicand) is multiplied by a ratio (disqualified ratio), the numerator of which is the sum of the portion of the basis difference for all RFAs that is taken into account and assigned to the U.S. taxable year of the section 901(m) payor, and the denominator of which is the portion of the foreign income reflected on the foreign tax return that relates to the foreign income tax amount included in the multiplicand. The numerator and the denominator of the disqualified ratio are referred to in the proposed regulations as the “aggregate basis difference” and “allocable foreign income,” respectively.

Allocable foreign income (the denominator of the disqualified ratio) and the foreign income tax amount (the multiplicand) are determined using the total amount of foreign income and foreign income tax amount reflected on the foreign income tax return that are allocable to the section 901(m) payor, instead of by reference only to the amounts determined with respect to the RFAs. The Treasury Department and the IRS have determined that this approach appropriately carries out the purposes of section 901(m) while avoiding the administrative and compliance burdens that would result from a requirement to trace amounts of income to RFAs and identify the portion of foreign income taxes imposed on that income.

If a foreign income tax amount is computed taking into account an FCCT, the multiplicand of the tentative disqualified tax amount computation is the sum of the foreign income tax amount and any FCCTs paid or accrued by, or considered paid or accrued by, the section 901(m) payor. The Treasury Department and the IRS have determined that it is appropriate to include any FCCTs in the multiplicand to better reflect the effective tax rate imposed on the aggregate basis difference. However, the tentative disqualified tax amount is reduced (but not below zero) to the extent any portion of the FCCTs is itself treated as a disqualified tax amount of the section 901(m) payor with respect to a different foreign income tax.

The aggregate basis difference in the numerator includes cost recovery amounts

and disposition amounts taken into account with respect to RFAs and assigned to the U.S. taxable year of the section 901(m) payor under proposed § 1.901(m)-5, as discussed in section VI. of this the Explanation of Provisions of this preamble. When the numerator and denominator are both positive amounts, the amount of aggregate basis difference included in the numerator is limited to the amount of foreign income in the denominator of the disqualified ratio (in other words, the allocable foreign income). This limitation ensures that multiplying the foreign income tax amount included in the multiplicand by the disqualified ratio would not produce a disqualified tax amount greater than 100 percent of the foreign income tax amount. See section IV.B. of the Explanation of Provisions section of this preamble for the treatment of any excess of the aggregate basis difference over the allocable foreign income as an aggregate basis difference carryover.

The denominator of the disqualified ratio is the allocable foreign income. When the entire foreign income tax amount reflected on a foreign tax return is paid or accrued by, or considered paid or accrued by, a single section 901(m) payor for U.S. income tax purposes, the allocable foreign income is simply the total foreign income reflected on the foreign tax return. In general, this will be the case when the section 901(m) payor is the foreign payor or owns a disregarded entity that is the foreign payor, unless there is a change in ownership or a change in entity classification in the foreign payor requiring an allocation of the foreign income tax amount of the foreign payor (a mid-year transaction).

If, however, the foreign income tax amount reflected on a foreign tax return is allocated to more than one person for U.S. income tax purposes, the allocable foreign income in the denominator of the disqualified ratio for a particular section 901(m) payor is equal to the portion of the foreign income reflected on the foreign tax return that relates to the foreign income tax amount allocated to, and considered paid or accrued by, that section 901(m) payor (and therefore that is included in the multiplicand of the tentative disqualified tax amount computation). Proposed § 1.901(m)-3(b)(2)(iii)(C) provides guidance on how to determine the allocable foreign

income in three types of cases: (i) the foreign income tax amount is allocated to a section 901(m) payor because the foreign payor is involved in a mid-year transaction, such as the transfer of a disregarded entity during the disregarded entity’s foreign taxable year or acquisitions involving elections under section 338 or 336(e); (ii) the foreign income tax amount is allocated to a section 901(m) payor that is a partner because the foreign payor is a partnership for U.S. income tax purposes that is legally liable for the foreign income tax amount under § 1.901-2(f)(4)(i) (or the foreign payor is a disregarded entity and its assets are owned for U.S. income tax purposes by an entity that is treated as a partnership for U.S. income tax purposes and that is legally liable for the foreign income tax amount under § 1.901-2(f)(4)(ii)); and (iii) the foreign income tax amount is allocated to a section 901(m) payor under § 1.901-2(f)(3)(i) because the section 901(m) payor is a member of a group whose income is taxed on a combined basis for foreign income tax purposes.

Notwithstanding the rules described in the two preceding paragraphs for determining allocable foreign income, if a section 901(m) payor fails to substantiate its allocable foreign income to the satisfaction of the Secretary, then proposed § 1.901(m)-3(b)(2)(iii)(D) provides that allocable foreign income will equal the amount determined by dividing the sum of the foreign income tax amount and the FCCTs that are paid or accrued by, or considered paid or accrued by, the section 901(m) payor, by the highest marginal tax rate applicable to income of the foreign payor under the relevant foreign income tax. See section 901(m)(3)(A).

If the numerator is less than zero, the denominator is less than or equal to zero, or the multiplicand is zero, the tentative disqualified tax amount (and therefore the disqualified tax amount) is zero. If the disqualified tax amount for a year either is zero or is limited by the foreign income tax amount paid or accrued by, or considered paid or accrued by, a section 901(m) payor, there will be an aggregate basis difference carryover as described in the next section.

## B. Aggregate basis difference carryover

Proposed § 1.901(m)-3(c) provides rules for determining the amount of aggregate basis difference carryover for a given U.S. taxable year of a section 901(m) payor that will be included in the section 901(m) payor's aggregate basis difference for the next U.S. taxable year (and therefore included in the numerator of the disqualified ratio for purposes of the next year's disqualified tax amount computation). The carryover reflects the extent to which the aggregate basis difference for a U.S. taxable year has not yet given rise to a disqualified tax amount.

If the disqualified tax amount is zero, none of the aggregate basis difference gives rise to a disqualified tax amount and therefore the full amount of the section 901(m) payor's aggregate basis difference for that year will be reflected in an aggregate basis difference carryover (positive or negative).

If the disqualified tax amount is not zero, an aggregate basis difference carryover may still arise in two situations. First, if the aggregate basis difference exceeds the section 901(m) payor's allocable foreign income (the denominator of the disqualified ratio) and therefore the amount of the aggregate basis difference included in the numerator is limited, the excess is reflected in an aggregate basis difference carryover. Second, if the tentative disqualified tax amount (which takes into account FCCTs) exceeds the foreign income tax amount paid or accrued by the section 901(m) payor (which does not include FCCTs), that excess tax amount is converted into an equivalent amount of aggregate basis difference that is reflected in an aggregate basis difference carryover. See Prop. § 1.901(m)-3(c)(2)(ii)(B).

## V. Determination of Basis Difference

Proposed § 1.901(m)-4 incorporates by cross reference the general rules in the temporary regulations for determining basis difference. Under these rules, basis difference is determined separately with respect to each foreign income tax for which an asset is an RFA.

Proposed § 1.901(m)-4(c)(1) provides for a foreign basis election, pursuant to which basis difference is equal to the U.S.

basis in the RFA immediately after the CAA less the foreign basis in the RFA immediately after the CAA (including any adjustments to the foreign basis resulting from the CAA). Proposed § 1.901(m)-4(c)(2) through (4) provide rules for making a foreign basis election. A foreign basis election generally is made by the RFA owner (U.S.). For example, in a section 338 CAA, the foreign basis election is made by the corporation that is the subject of the qualified stock purchase (new target as defined in § 1.338-2(c)(17)). If the RFA owner (U.S.) is a partnership, however, each partner in the partnership (and not the partnership) may independently make a foreign basis election. A foreign basis election is made separately for each CAA and with respect to each foreign income tax and each foreign payor. For this purpose, a series of CAAs occurring as part of a plan (referred to in the regulations as an "aggregated CAA transaction") are treated as a single CAA. The proposed regulations contain examples illustrating the scope of the foreign basis election.

The election is made by using foreign basis to determine the basis differences for purposes of computing a disqualified tax amount and an aggregate basis difference carryover. The election generally must be reflected on a timely filed original federal income tax return for the first U.S. taxable year that the foreign basis election is relevant. Proposed § 1.901(m)-4(c)(5) provides an exception for certain cases in which the RFA owner (U.S.) is a partnership. This exception generally provides relief when one or more partners and the partnership have agreed that the partnership would determine whether to provide the partners with information to apply section 901(m) based on foreign basis and, in fact, the partnership provided the information to the partner using foreign basis, but when the partner timely filed its tax return it failed to report the application of section 901(m). The purpose of the relief is to address situations in which a partner must file an amended return in order to properly reflect the application of section 901(m) but does not have access to the necessary information to apply section 901(m) using U.S. basis. The criteria for qualifying for this relief should prevent partners from

using hindsight in determining whether to make the foreign basis election.

Proposed § 1.901(m)-4(c)(6) provides another exception to the requirement to make the election in a timely filed original federal income tax return that applies if a taxpayer chooses to consistently apply these proposed regulations retroactively to all CAAs occurring before the regulations are issued in final form, including CAAs for which the taxpayer chooses not to make a foreign basis election. In this case, a foreign basis election may be reflected on a timely filed amended federal income tax return (or tax returns, as appropriate), provided that all amended returns are filed no later than one year following the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

## VI. Basis Difference Taken into Account

Section 1.901(m)-5 provides rules for determining the amount of basis difference with respect to an RFA that is taken into account in a given U.S. taxable year (referred to in the regulations as "allocated basis difference"). This allocated basis difference is used to compute a disqualified tax amount for a U.S. taxable year. Basis difference is taken into account in two ways: under an applicable cost recovery method or as a result of a disposition of the RFA.

For purposes of the discussion under this section VI of the Explanation of Provisions section of the preamble, unless otherwise indicated, a reference to direct ownership of an interest in an entity refers to direct ownership for U.S. income tax purposes, which includes ownership through one or more disregarded entities. A reference to indirect ownership of an interest in an entity refers to ownership through one or more entities that are treated as fiscally transparent for U.S. income tax purposes, at least one of which is not a disregarded entity. Finally, a reference to indirect ownership of an interest in an entity for foreign income tax purposes means ownership through one or more entities that are treated as fiscally transparent for foreign income tax purposes.

## A. Cost recovery rules

### 1. Determining a cost recovery amount

Proposed § 1.901(m)-5(b)(2)(i) incorporates by cross reference the general rule in the temporary regulations that a cost recovery amount for an RFA is determined by applying an applicable cost recovery method to the basis difference rather than to the U.S. basis of the RFA.

Proposed § 1.901(m)-5(b)(2)(ii) provides that if the entire U.S. basis of the RFA is not subject to the same cost recovery method, the applicable cost recovery method for determining the cost recovery amount is the cost recovery method that applies to the portion of the U.S. basis that corresponds to the basis difference.

Proposed § 1.901(m)-5(b)(3) provides that, for purposes of section 901(m), an applicable cost recovery method includes any method for recovering the cost of property over time for U.S. income tax purposes (each application of a method giving rise to a “U.S. basis deduction”). Such methods include depreciation, amortization, or depletion, as well as a method that allows the cost (or a portion of the cost) of property to be expensed in the year of acquisition or in the placed-in-service year, such as under section 179. Applicable cost recovery methods do not include any provision allowing for the recovery of U.S. basis upon a disposition of an RFA.

### 2. Attributing or allocating a cost recovery amount to a section 901(m) payor

Under proposed § 1.901(m)-5(b)(1), when an RFA owner (U.S.) is a section 901(m) payor, all of the cost recovery amount is attributed to the section 901(m) payor and assigned to the U.S. taxable year of the section 901(m) payor in which the corresponding U.S. basis deduction with respect to the RFA is taken into account under the applicable cost recovery method. This is the case regardless of whether the deduction is deferred or disallowed under other Code provisions (for example, see section 263A, which requires the capitalization of certain costs and expenses).

If instead the RFA owner (U.S.) is not a section 901(m) payor but a fiscally transparent entity for U.S. income tax purposes in which a section 901(m) payor directly or indirectly owns an interest, proposed § 1.901(m)-5(d)(2) allocates all or a portion of the cost recovery amount to the section 901(m) payor. Under those rules, a cost recovery amount is allocated to the section 901(m) payor to the extent the U.S. basis deduction that corresponds to the cost recovery amount (both of which are determined at the level of the RFA owner (U.S.)) is (or will be) included in the section 901(m) payor’s distributive share of the income of the RFA owner (U.S.) for U.S. income tax purposes. Proposed § 1.901(m)-5(d)(6) assigns an allocated cost recovery amount to the U.S. taxable year of the section 901(m) payor that includes the last day of the U.S. taxable year of the RFA owner (U.S.) in which the RFA owner (U.S.) takes into account the corresponding U.S. basis deduction (without regard to whether the deduction is deferred or disallowed under other Code provisions).

Special rules under proposed § 1.901(m)-5(e), discussed in section VI.D of the Explanation of Provisions section of this preamble, allocate a cost recovery amount that arises from an RFA with respect to certain section 743(b) CAAs. In addition, special rules under proposed § 1.901(m)-5(g), discussed in section VI.F of the Explanation of Provisions section of this preamble, allocate a cost recovery amount to a section 901(m) payor in certain cases in which the RFA owner (U.S.) either is a reverse hybrid or is a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid. A reverse hybrid is an entity that is treated as a corporation for U.S. income tax purposes but as a fiscally transparent entity for foreign income tax purposes.

## B. General disposition rules

### 1. Definition of disposition and determining a disposition amount

Proposed § 1.901(m)-1(a)(10) defines (by cross reference to the temporary regulations) a disposition for purposes of section 901(m) as an event that results in gain

or loss being recognized with respect to an RFA for purposes of U.S. income tax, a foreign income tax, or both. Proposed § 1.901(m)-5(c)(2) incorporates by cross reference the rules provided in the temporary regulations for determining the amount of basis difference taken into account upon a disposition of an RFA (the disposition amount). Section 1.901(m)-5T(c)(2) provides that, if a disposition of an RFA is fully taxable for U.S. and foreign income tax purposes, the disposition amount will be any remaining unallocated basis difference (positive or negative). Section 1.901(m)-5T(c)(2) further provides that, if a disposition of an RFA is not fully taxable for both U.S. and foreign income tax purposes and the RFA has a *positive* basis difference, the disposition amount is based solely on the amount, if any, of foreign disposition gain and U.S. disposition loss. If, on the other hand, a disposition of an RFA is not fully taxable for both U.S. and foreign income tax purposes and the RFA has a *negative* basis difference, the temporary regulations provide that the disposition amount is based solely on the amount, if any, of foreign disposition loss and U.S. disposition gain. See section V.B of the preamble to the temporary regulations for a further discussion of these provisions.

### 2. Attributing or allocating a disposition amount to a section 901(m) payor

Under proposed § 1.901(m)-5(c)(1), when the RFA owner (U.S.) is a section 901(m) payor, all of the disposition amount is attributed to the section 901(m) payor and assigned to the U.S. taxable year of the section 901(m) payor in which the disposition occurs.

If instead the RFA owner (U.S.) is not a section 901(m) payor but a fiscally transparent entity for U.S. income tax purposes in which a section 901(m) payor directly or indirectly owns an interest, proposed § 1.901(m)-5(d), discussed in section VI.C of the Explanation of Provisions section of this preamble, allocates all or a portion of a disposition amount to the section 901(m) payor and assigns it to a U.S. taxable year of the section 901(m) payor.

Special rules under proposed § 1.901(m)-5(e), discussed in section VI.D of the

Explanation of Provisions section of this preamble, allocate a disposition amount to a section 901(m) payor and assign it to a U.S. taxable year of the section 901(m) payor when the disposition amount arises from an RFA with respect to certain section 743(b) CAAs. Special rules under proposed § 1.901(m)-5(f), discussed in section VI.E of the Explanation of Provisions section of this preamble, allocate a disposition amount attributable to foreign disposition gain or foreign disposition loss to a section 901(m) payor and assign it to a U.S. taxable year of the section 901(m) payor when there is a mid-year transaction. Special rules under proposed § 1.901(m)-5(g), discussed in section VI.F of the Explanation of Provisions section of this preamble, allocate a disposition amount to a section 901(m) payor and assign it to a U.S. taxable year of the section 901(m) payor in certain cases in which the RFA owner (U.S.) either is a reverse hybrid or is a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid.

### *C. Rules for allocating and assigning a disposition amount when the RFA owner (U.S.) is a fiscally transparent entity*

This section describes the rules for allocating a disposition amount to a section 901(m) payor when the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes in which a section 901(m) payor directly or indirectly owns an interest, as well as rules for assigning the allocated amount to a U.S. taxable year of the section 901(m) payor.

The allocation rules (discussed in sections VI.C.1 and 2 of the Explanation of Provisions section of this preamble) vary depending on whether the disposition amount is attributable to foreign disposition gain or loss or U.S. disposition gain or loss. The rules for determining the extent to which a disposition amount is attributable to foreign or U.S. disposition gain or loss are discussed in section VI.C.3 of the Explanation of Provisions section of this preamble. The rules for assigning allocated disposition amounts to a U.S. taxable year of a section 901(m) payor are discussed in section VI.C.4 of

the Explanation of Provisions section of this preamble.

#### 1. Allocation of a disposition amount attributable to foreign disposition gain or foreign disposition loss

Proposed § 1.901(m)-5(d)(3) addresses the allocation of a disposition amount attributable to foreign disposition gain or foreign disposition loss of an RFA. These rules should be interpreted and applied in a manner consistent with the principle that a disposition amount attributable to foreign disposition gain or foreign disposition loss should be allocated to a section 901(m) payor in the same proportion that the gain or loss is taken into account in computing a foreign income tax amount that is paid or accrued by, or considered paid or accrued by, the section 901(m) payor. This is because, for example, if an RFA has a positive basis difference, a disposition amount attributable to foreign disposition gain represents an amount of gain in years following the CAA that is included in foreign income but never included in U.S. taxable income or earnings and profits because of the step-up in the U.S. basis of the RFA that occurred as a result of the CAA. Accordingly, to the extent a foreign disposition gain is taken into account in computing a foreign income tax amount, a portion of that foreign income tax amount should be disallowed as a foreign tax credit under section 901(m). Similarly, if an RFA has a negative basis difference and a foreign disposition loss is taken into account in computing a foreign income tax amount, this should result in an offset to the amount of the foreign income tax that otherwise would be disallowed as a foreign tax credit under section 901(m) as a result of a positive basis difference with respect to one or more other RFAs.

There are two separate rules for identifying the extent to which a foreign disposition gain or foreign disposition loss is taken into account in computing a foreign income tax amount that is paid or accrued by, or considered paid or accrued by, a section 901(m) payor that directly or indirectly owns an interest in an RFA owner (U.S.) that is a fiscally transparent entity for U.S. income tax purposes. The first rule, which is described in proposed

§ 1.901(m)-5(d)(3)(ii), applies when the foreign income tax amount is not allocated, for example, when the foreign payor is the section 901(m) payor. The second rule, which is described in proposed § 1.901(m)-5(d)(3)(iii), applies when the foreign income tax amount is allocated, for example, under § 1.704-1(b)(4)(viii) when the foreign payor is a partnership for U.S. income tax purposes in which the section 901(m) payor is a partner.

#### a. First allocation rule

The first allocation rule applies when a section 901(m) payor, or a disregarded entity directly owned by a section 901(m) payor, is a foreign payor whose foreign income includes a distributive share of the foreign income (that includes the foreign disposition gain or foreign disposition loss) of the RFA owner (foreign). In this structure, the entire foreign income tax amount reflected on the foreign income tax return of the foreign payor is paid or accrued by, or considered paid or accrued by, the section 901(m) payor. This will be the case when the RFA owner (U.S.) is treated as a fiscally transparent entity not just for U.S. income tax purposes, but also for foreign income tax purposes, and the section 901(m) payor directly or indirectly owns an interest in the RFA owner (U.S.), provided that, in the case of indirect ownership, any entities in the ownership chain between the section 901(m) payor and the RFA owner (U.S.), or, when one or more disregarded entities are directly owned by the section 901(m) payor, between the lowest-tier disregarded entity and the RFA owner (U.S.), are fiscally transparent for both U.S. and foreign income tax purposes. In these cases, the RFA owner (U.S.) and the RFA owner (foreign) are the same entity, except in the unusual case where the RFA owner (U.S.) is an entity that is disregarded as separate from its owner for foreign income tax purposes.

The first allocation rule allocates a portion of a disposition amount attributable to foreign disposition gain or foreign disposition loss, as applicable, to the section 901(m) payor proportionally to the amount of the foreign disposition gain or foreign disposition loss that is included in the foreign payor's (in other words, the

section 901(m) payor or the disregarded entity, as the case may be) distributive share of the foreign income of the RFA owner (foreign) for foreign income tax purposes.

The following example illustrates the first allocation rule. A domestic entity that is a corporation for both U.S. and foreign income tax purposes (corporate partner) directly owns, for both U.S. and foreign income tax purposes, an interest in a foreign entity that is a partnership for both U.S. and foreign income tax purposes and that is the RFA owner (U.S.) and the RFA owner (foreign). In this case, when the partnership recognizes foreign disposition gain with respect to an RFA, the foreign income tax amount with respect to such gain is paid by the partners on their distributive shares of the foreign income of the partnership that includes the foreign disposition gain. The corporate partner, and not the partnership, is therefore a foreign payor and a section 901(m) payor. Accordingly, under the first allocation rule, a disposition amount attributable to foreign disposition gain is allocated to the corporate partner proportionally to the amount of the foreign disposition gain that is included in the corporate partner's distributive share of the foreign income of the partnership. Thus, for example, if the partnership recognizes \$100 of foreign disposition gain and 50 percent of that gain is included in the corporate partner's distributive share of the foreign income of the partnership, and the disposition amount attributable to the foreign disposition gain is \$40, the corporate partner would be allocated \$20 of that amount (50 percent of \$40). The same result would apply if the corporate partner directly owned the partnership interest through a disregarded entity that is the foreign payor.

#### b. Second allocation rule

The second allocation rule applies when, instead of a section 901(m) payor or a disregarded entity directly owned by a section 901(m) being a foreign payor, a section 901(m) payor directly or indirectly owns an interest in a fiscally transparent entity for U.S. income tax purposes (other than a disregarded entity directly owned by the section 901(m) payor) that is a

foreign payor whose foreign income includes all or a portion of the foreign income (that includes the foreign disposition gain or foreign disposition loss) of the RFA owner (foreign). Therefore, the section 901(m) payor is considered to pay or accrue only an allocated portion of the foreign income tax amount reflected on the foreign income tax return of the foreign payor. This will be the case when a section 901(m) payor directly or indirectly owns an interest in the foreign payor, and the foreign payor is (i) the RFA owner (U.S.), (ii) another fiscally transparent entity for U.S. income tax purposes (other than a disregarded entity directly owned by a section 901(m) payor) that directly or indirectly owns an interest in the RFA owner (U.S.) for both U.S. and foreign income tax purposes, or (iii) a disregarded entity directly owned by the RFA owner (U.S.). In each of these cases, the entity subject to tax for purposes of the foreign income tax (that is, the foreign payor) is treated as a fiscally transparent entity for U.S. income tax purposes.

The mechanics of the second allocation rule are different than those of the first allocation rule. This is because the second allocation rule applies when neither the section 901(m) payor, nor a disregarded entity directly owned by a section 901(m) payor, is a foreign payor that takes into account a foreign disposition gain or foreign disposition loss for purposes of calculating a foreign income tax amount, but instead, for U.S. income tax purposes, a foreign income tax amount of the foreign payor is allocated to, and considered paid or accrued by, the section 901(m) payor. Accordingly, the second allocation rule allocates a portion of a disposition amount attributable to foreign disposition gain or foreign disposition loss, as applicable, to the section 901(m) payor proportionally to the amount of the foreign disposition gain or foreign disposition loss that is included in the allocable foreign income of the section 901(m) payor. As described in section IV.A of the Explanation of Provisions section of this preamble, allocable foreign income is generally the portion of foreign income of a foreign payor that relates to the portion of the foreign income tax amount of that foreign payor that is allocated to and considered paid or accrued by a section 901(m) payor.

The following example illustrates the second allocation rule. A domestic entity that is a corporation for both U.S. and foreign income tax purposes (corporate partner) directly owns an interest in a foreign entity, the RFA owner (U.S.) and RFA owner (foreign), that is a partnership for U.S. income tax purposes but a corporation for purposes of a foreign income tax (a hybrid partnership). In this case, when the hybrid partnership recognizes foreign disposition gain with respect to an RFA, it is the hybrid partnership, rather than the partners, that takes the gain into account for purposes of calculating a foreign income tax amount. The hybrid partnership is therefore the foreign payor. For U.S. income tax purposes, a foreign income tax amount of the hybrid partnership is allocated to, and considered paid or accrued by, its partners, including the corporate partner that is a section 901(m) payor (see §§ 1.702-1(a)(6), 1.704-1(b)(4)(viii), and 1.901-2(f)(4)(i)). Under the second allocation rule, a disposition amount attributable to foreign disposition gain is allocated to the corporate partner proportionally to the amount of the foreign disposition gain that is included in the corporate partner's allocable foreign income. Thus, for example, if the hybrid partnership pays a foreign income tax amount of \$30 on \$200 of foreign income that includes \$100 of foreign disposition gain and \$15 of the foreign income tax amount (50 percent of \$30) is allocated to and considered paid by the corporate partner, the corporate partner's allocable foreign income would be \$100 (50 percent of the \$200 foreign income to which the foreign income tax amount relates), which would include \$50 of foreign disposition gain (50 percent of \$100). If the disposition amount attributable to the foreign disposition gain is \$60, the corporate partner would be allocated \$30 of that amount (\$60 multiplied by 50 percent, the portion of the total foreign disposition gain that is included in the corporate partner's allocable foreign income).

In this example, the analysis would be similar if the corporate partner instead indirectly owned the partnership interest (for example through an upper-tier partnership), because the corporate partner would continue to be the section 901(m) payor and the hybrid partnership would

continue to be the RFA owner (U.S.), the RFA owner (foreign), and the foreign payor.

## 2. Allocation of a disposition amount attributable to U.S. disposition gain or U.S. disposition loss

Proposed § 1.901(m)-5(d)(4) addresses the allocation of a disposition amount attributable to U.S. disposition gain or U.S. disposition loss. Such disposition amounts are allocated to a section 901(m) payor based on the portion of the U.S. disposition gain or U.S. disposition loss (which are determined at the level of the RFA owner (U.S.)) that is (or will be) included in the section 901(m) payor's distributive share of the income of the RFA owner (U.S.) for U.S. income tax purposes.

## 3. Determining the extent to which a disposition amount is attributable to foreign or U.S. disposition gain or loss

### a. Positive basis difference

When an RFA has a positive basis difference, a disposition amount arises from a disposition of the RFA only if the disposition results in a foreign disposition gain or a U.S. disposition loss (or both). To allocate such a disposition amount to a section 901(m) payor, it is necessary to determine the extent to which the disposition amount is attributable to foreign disposition gain or U.S. disposition loss.

Proposed § 1.901(m)-5(d)(5)(i) provides that if the disposition results in either a foreign disposition gain or a U.S. disposition loss, but not both, the entire disposition amount is attributable to foreign disposition gain or U.S. disposition loss, as applicable, even if the disposition amount exceeds the foreign disposition gain or the absolute value of the U.S. disposition loss. If the disposition results in both a foreign disposition gain and a U.S. disposition loss, the disposition amount is attributable first to foreign disposition gain to the extent thereof, and the excess disposition amount, if any, is attributable to the U.S. disposition loss, even if the excess disposition amount exceeds the absolute value of the U.S. disposition loss. In the case of a disposition that is fully taxable for both U.S. and foreign income tax purposes, a disposition

amount may exceed the sum of the foreign disposition gain and the absolute value of the U.S. disposition loss if, immediately before the CAA, the foreign basis in the RFA was greater than the U.S. basis, and a foreign basis election was not made.

### b. Negative basis difference

When an RFA has a negative basis difference, a disposition amount arises from a disposition of the RFA only if the disposition results in a foreign disposition loss or a U.S. disposition gain (or both). To allocate such a disposition amount to a section 901(m) payor, it is necessary to determine the extent to which the disposition amount is attributable to foreign disposition loss or U.S. disposition gain.

Proposed § 1.901(m)-5(d)(5)(ii) provides rules for making this determination when there is a negative basis difference that are similar to those provided in proposed § 1.901(m)-5(d)(5)(i) for a positive basis difference.

## 4. Assigning a disposition amount to a U.S. taxable year of a section 901(m) payor

When a disposition amount is allocated to a section 901(m) payor under proposed § 1.901(m)-5(d), proposed § 1.901(m)-5(d)(6) provides that the disposition amount is assigned to the U.S. taxable year of the section 901(m) payor that includes the last day of the U.S. taxable year of the RFA owner (U.S.) in which the disposition occurs.

### D. *Special allocation rules for certain section 743(b) CAAs*

Proposed § 1.901(m)-5(e) provides that when a section 901(m) payor acquires a partnership interest in a section 743(b) CAA, including a section 743(b) CAA with respect to a lower-tier partnership that results from a direct acquisition by the section 901(m) payor of an interest in an upper-tier partnership, a cost recovery amount or a disposition amount that arises from an RFA with respect to that CAA is allocated to the acquiring section 901(m) payor. These amounts are assigned to the U.S. taxable year of the section 901(m) payor that includes the last day of the U.S. taxable year of the partnership in which,

in the case of a cost recovery amount, the partnership takes into account the corresponding U.S. basis deduction, or, in the case of a disposition amount, the disposition occurs.

This special rule does not apply if it is another partnership, and not a section 901(m) payor, that acquires a partnership interest in a section 743(b) CAA. In that case, the general rules for allocating a cost recovery amount or disposition amount when the RFA owner (U.S.) is a fiscally transparent entity apply.

### E. *Special allocation rules for certain mid-year transactions*

Proposed § 1.901(m)-5(f) provides rules for allocating a disposition amount when there is a disposition of an RFA during a foreign taxable year in which the foreign payor is involved in a mid-year transaction, and the disposition results in foreign disposition gain or foreign disposition loss that is allocated under the principles of § 1.1502-76(b) to the persons involved in the mid-year transaction for purposes of allocating the foreign income tax amount of the foreign payor. A typical example is when a section 901(m) payor owns a disregarded entity that is both an RFA owner (foreign) and the foreign payor, and the disregarded entity sells the RFA in the same year that the section 901(m) payor sells the disregarded entity to another section 901(m) payor. If the RFA has positive unallocated basis difference and there is foreign disposition gain on the sale of the RFA, the sale will give rise to a disposition amount that will be used by the section 901(m) payors to calculate a disqualified portion of the foreign income tax amount reflected on the foreign income tax return of the disregarded entity. Pursuant to § 1.901-2(f)(4)(ii), that foreign income tax amount must be allocated between the buyer and seller of the disregarded entity based on the respective portions of foreign income that are attributable under the principles of § 1.1502-76(b) to the buyer's and seller's respective periods of ownership of the disregarded entity during its foreign taxable year. Under proposed § 1.901(m)-5(f)(2), the disposition amount attributable to foreign disposition gain is similarly allocated between the buyer and the seller based on

the principles in proposed § 1.901(m)–5(d), discussed in section VI.C of the Explanation of Provisions section of this preamble, that apply to allocate a disposition amount when the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes.

#### F. *Special allocation rules for certain reverse hybrids*

Proposed § 1.901(m)–5(g) addresses the allocation of cost recovery amounts and disposition amounts when the RFA owner (U.S.) is either a reverse hybrid or a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid for U.S. and foreign income tax purposes, and in either case, a foreign payor directly or indirectly owns an interest in the reverse hybrid for foreign income tax purposes and therefore includes in its foreign income a distributive share of the foreign income (that includes the foreign disposition gain or foreign disposition loss) of the RFA owner (foreign). These allocation rules are similar to the allocation rules discussed in section VI.C.1 of the Explanation of Provisions section of this preamble that apply to allocate a disposition amount attributable to foreign disposition gain or foreign disposition loss when the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes. These rules are broader in scope, however, because they apply to allocate not just foreign disposition gain or foreign disposition loss, but rather, both cost recovery amounts and entire disposition amounts (which may be attributable, in whole or in part, to U.S. disposition gain or U.S. disposition loss). This is because the basis difference giving rise to such amounts may not be taken into account in computing U.S. taxable income or earnings and profits of the owners of the reverse hybrid until one or more subsequent U.S. taxable years (for example, upon the receipt of a distribution of property from the reverse hybrid).

These rules should be interpreted and applied in a manner consistent with the principle that a cost recovery amount or a disposition amount (or both) should be allocated to a section 901(m) payor proportionally to the amount of the foreign

income of the RFA owner (foreign) that is taken into account in computing a foreign income tax amount of a foreign payor that is paid or accrued by, or considered paid or accrued by, the section 901(m) payor.

There are two separate rules for allocating a cost recovery amount or disposition amount to a section 901(m) payor when the RFA owner (U.S.) either is a reverse hybrid or a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid for U.S. and foreign income tax purposes. The first rule, which is described in § 1.901(m)–5(g)(2), applies when the foreign income tax amount is not allocated, for example, when the foreign payor is the section 901(m) payor. The second rule, which is described in § 1.901(m)–5(g)(3), applies when the foreign income tax amount is allocated, for example, under § 1.704–1(b)(4)(viii) when the foreign payor is a partnership for U.S. income tax purposes in which the section 901(m) payor is a partner.

##### 1. First allocation rule

The first allocation rule applies when a section 901(m) payor, or a disregarded entity directly owned by a section 901(m) payor, is the foreign payor whose foreign income includes a distributive share of the foreign income of the RFA owner (foreign). In this structure, the entire foreign income tax amount reflected on the foreign income tax return of the foreign payor is paid or accrued by, or considered paid or accrued by, the section 901(m) payor. This will be the case when a section 901(m) payor directly or indirectly owns an interest in the reverse hybrid, provided that in the case of indirect ownership, any entities in the ownership chain between the section 901(m) payor and the reverse hybrid, or, when one or more disregarded entities are directly owned by the section 901(m) payor, between the lowest-tier disregarded entity and the reverse hybrid, are fiscally transparent for both U.S. and foreign income tax purposes. In these cases, the RFA owner (U.S.) and the RFA owner (foreign) are the same entity, except in the unusual case where the RFA owner (U.S.) is an entity that is disre-

garded as separate from its owner for foreign income tax purposes.

The first allocation rule allocates a portion of a cost recovery amount or a disposition amount to the section 901(m) payor proportionally to the amount of the foreign income of the RFA owner (foreign) that is included in the foreign income of the foreign payor (in other words, the section 901(m) payor or the disregarded entity, as the case may be).

The following example illustrates the first allocation rule. A domestic entity that is a corporation for both U.S. and foreign income tax purposes (corporate owner) owns an interest in a reverse hybrid that is the RFA owner (U.S.) and the RFA owner (foreign). A foreign income tax amount with respect to the foreign income of the reverse hybrid is paid by the owners of the reverse hybrid on their distributive shares of such foreign income. The corporate owner, and not the reverse hybrid, is therefore a foreign payor and a section 901(m) payor. Under the first allocation rule, a cost recovery amount or a disposition amount is allocated to the corporate owner proportionally to the amount of the foreign income of the reverse hybrid that is included in the foreign income of the corporate owner. Thus, for example, if 50 percent of the foreign income of the reverse hybrid is included in the foreign income of the corporate owner, the corporate owner would be allocated 50 percent of a cost recovery amount or a disposition amount with respect to an RFA owned by the reverse hybrid. The same result would apply if the corporate owner directly owned the interest in the reverse hybrid through a disregarded entity that is the foreign payor.

Alternatively, if the reverse hybrid was not the RFA owner (foreign) but instead the reverse hybrid owned an interest in the RFA owner (U.S.) and RFA owner (foreign), which is a partnership for both U.S. and foreign income tax purposes, and 60 percent of the foreign income of the partnership is included in the foreign income of the reverse hybrid (and therefore 30 percent (50 percent of 60 percent) of the foreign income of the partnership is included in the foreign income of the corporate owner), the corporate owner would be allocated 30 percent of a cost recovery

amount or a disposition amount with respect to an RFA owned by the partnership.

## 2. Second allocation rule

The second allocation rule applies when instead of a section 901(m) payor, or a disregarded entity directly owned by a section 901(m) payor, being a foreign payor, a section 901(m) payor directly or indirectly owns an interest in the foreign payor whose foreign income includes a distributive share of the foreign income of the RFA owner (foreign). Therefore, the section 901(m) payor is considered to pay or accrue only an allocated portion of the foreign income tax amount reflected on the foreign income tax return of the foreign payor. This will be the case when the foreign payor is a fiscally transparent entity for U.S. income tax purposes (other than a disregarded entity directly owned by the section 901(m) payor) that either directly or indirectly owns an interest in the RFA owner (foreign) for foreign income tax purposes. In these cases, the RFA owner (U.S.) and the RFA owner (foreign) are the same entity, except in the unusual case where the RFA owner (U.S.) is an entity that is disregarded as separate from its owner for foreign income tax purposes.

The mechanics of the second allocation rule are different than those of the first allocation rule. This is because the second allocation rule applies when neither a section 901(m) payor, nor a disregarded entity directly owned by a section 901(m) payor, is a foreign payor that takes into account the foreign income of the RFA owner (foreign) for purposes of calculating a foreign income tax amount, but instead, for U.S. income tax purposes, a foreign income tax amount of the entity that is the foreign payor is allocated to, and considered paid or accrued by, the section 901(m) payor. Accordingly, the second allocation rule allocates a portion of cost recovery amounts and disposition amounts proportionally to the amount of the foreign income of the RFA owner (foreign) that is included in the foreign income of the foreign payor that is then included in the allocable foreign income of the section 901(m) payor. As described in section IV.A of the Explanation of Provisions section of this preamble, allocable

foreign income is generally the portion of foreign income of a foreign payor that relates to the portion of the foreign income tax amount of that foreign payor that is allocated to and considered paid or accrued by a section 901(m) payor.

The following example illustrates the second allocation rule. A domestic entity that is a corporation for both U.S. and foreign income tax purposes (corporate partner) owns an interest in an entity that is a partnership for U.S. income tax purposes but a corporation for foreign income tax purposes (hybrid partnership), which, in turn, owns an interest in a reverse hybrid that is the RFA owner (U.S.) and the RFA owner (foreign). A foreign income tax amount with respect to the foreign income of the reverse hybrid is paid by the owners of the reverse hybrid on their distributive shares of such foreign income. Therefore, the hybrid partnership, rather than its partners, is the foreign payor. For U.S. income tax purposes, the foreign income tax amount paid or accrued by the hybrid partnership is allocated to, and considered paid or accrued by, the corporate partner that is the section 901(m) payor (see §§ 1.702-1(a)(6), 1.704-1(b)(4)(viii), and 1.901-2(f)(4)(i)). Under the second allocation rule, a cost recovery amount or a disposition amount with respect to an RFA owned by the reverse hybrid is allocated to the corporate partner proportionally to the amount of foreign income of the reverse hybrid that is taken into account in determining the foreign income of the hybrid partnership and then the allocable foreign income of the corporate partner. Thus, for example, if the reverse hybrid has \$500 of foreign income and the hybrid partnership pays a foreign income tax amount of \$30 on \$200 of foreign income that includes a \$100 distributive share of the foreign income of the reverse hybrid (20 percent of \$500) and \$15 of the foreign income tax amount (50 percent of \$30) is allocated to and considered paid by the corporate partner, then the corporate partner's allocable foreign income would be \$100 (50 percent of the \$200 foreign income to which the foreign income tax amount relates). A cost recovery amount or disposition amount with respect to the RFAs owned by the reverse hybrid would be allocated 10 percent to the corporate partner (the corpo-

rate partner's 50 percent share of the hybrid partnership's 20 percent share of the reverse hybrid's foreign income).

## VII. Successor Rules

Proposed § 1.901(m)-6 provides successor rules for applying section 901(m) following a transfer of RFAs that have basis difference that has not yet been fully taken into account (referred to in the regulations as "unallocated basis difference") as well as for determining when an aggregate basis difference carryover of a section 901(m) payor either becomes an aggregate basis difference carryover of the section 901(m) payor with respect to another foreign payor or is transferred to another section 901(m) payor.

### A. Unallocated basis difference

Proposed § 1.901(m)-6(b)(1) and (2) incorporate by cross reference the successor rules set forth in the temporary regulations, which provide generally that section 901(m) continues to apply to an RFA after it has been transferred for U.S. income tax purposes if the RFA continues to have unallocated basis difference following the transfer (a successor transaction).

Proposed § 1.901(m)-6(b)(3) sets forth two clarifications for applying the successor rules. First, if an asset is an RFA with respect to more than one foreign income tax, the successor rules apply separately with respect to each foreign income tax. Second, any subsequent cost recovery amount for an RFA transferred in a successor transaction will be determined based on the applicable cost recovery method that applies to the U.S. basis (or portion thereof) that corresponds to the unallocated basis difference. Thus, if a successor transaction restarts the depreciation schedule for an RFA, the transaction may result in unallocated basis difference being taken into account at a different recovery rate than otherwise would have applied.

Proposed § 1.901(m)-6(b)(4)(iii) also incorporates by cross reference the rule set forth in the temporary regulations that provides an exception to the general rule when an RFA is subject to multiple section 743(b) CAAs. See section VI.B. of the Explanation of Provisions section of

the preamble to the temporary regulations for a discussion of those provisions.

Proposed § 1.901(m)-6(b)(4)(ii), which is not included in the temporary regulations, provides an exception to the general successor rule if a foreign basis election is made under proposed § 1.901(m)-4(c) with respect to a subsequent CAA that otherwise would trigger the rules for successor transactions. If a foreign basis election is made with respect to a foreign income tax, the only basis difference that will be taken into account after the subsequent CAA with respect to that foreign income tax is the basis difference determined for the subsequent CAA.

#### B. Aggregate basis difference carryover

Proposed § 1.901(m)-6 provides successor rules for aggregate basis difference carryovers, the computation of which is described in section IV.B of the Explanation of Provisions section of this preamble. An aggregate basis difference carryover is treated as a tax attribute of the section 901(m) payor that retains its character as an aggregate basis difference carryover with respect to a foreign income tax and a foreign payor and with respect to a separate category, as described in § 1.904-4(m) (including the section 904(d) categories). When a section 901(m) payor transfers its assets in a transaction to which section 381 applies, proposed § 1.901(m)-6(c)(1) provides that any aggregate basis difference carryovers of the section 901(m) payor are transferred to the corporation that succeeds to the earnings and profits, if any. When substantially all of the assets of one foreign payor are transferred to another foreign payor, both of which are directly or indirectly owned by the same section 901(m) payor, proposed § 1.901(m)-6(c)(2) provides that an aggregate basis difference carryover of the section 901(m) payor with respect to the transferor foreign payor becomes an aggregate basis difference carryover of the section 901(m) payor with respect to the transferee foreign payor.

Proposed § 1.901(m)-6(c)(3) provides an anti-abuse rule that would transfer an aggregate basis difference carryover when, with a principal purpose of avoiding the application of section 901(m),

there is a transfer of assets or a change in either the allocation of foreign income for foreign income tax purposes or the allocation of foreign income tax amounts for U.S. income tax purposes that is intended to separate foreign income tax amounts from the related aggregate basis difference carryover. This anti-abuse rule would apply, for example, if, with the principal purpose of avoiding the application of section 901(m), a partnership agreement is amended in order to reduce the allocation of foreign income to a partner that is a section 901(m) payor with an aggregate basis difference carryover.

#### VIII. De Minimis Rules

Proposed § 1.901(m)-7 describes de minimis rules under which certain basis differences are not taken into account for purposes of section 901(m). This determination is made when an asset subject to a CAA first becomes an RFA. If that same asset is also an RFA by reason of being subject to a subsequent CAA, the de minimis tests are applied only to the additional basis difference, if any, that results from the subsequent CAA. Accordingly, any unallocated basis difference that arose from the prior CAA that did not qualify for the de minimis exemption at the time of the prior CAA will not be retested at the time of the subsequent CAA.

In general, a basis difference with respect to an RFA is not taken into account for purposes of section 901(m) if either (i) the sum of the basis differences for all RFAs with respect to the CAA is less than the greater of \$10 million or 10 percent of the total U.S. basis of all RFAs immediately after the CAA; or (ii) the RFA is part of a class of RFAs for which the sum of the basis differences of all RFAs in the class is less than the greater of \$2 million or 10 percent of the total U.S. basis of all RFAs in the class. For this purpose, the classes of RFAs are the seven asset classes defined in § 1.338-6(b).

The Treasury Department and the IRS decided that transactions between related parties should be more tightly regulated, and therefore, the threshold dollar amounts and percentages to meet the de minimis exemptions for related party CAAs are lower than those for unrelated party CAAs, replacing the terms “\$10 mil-

lion,” “10 percent,” and “\$2 million” wherever they occur with the terms “\$5 million,” “5 percent,” and “\$1 million,” respectively. In addition, an anti-abuse provision at proposed § 1.901(m)-7(e) denies application of the de minimis exemptions to CAAs between related parties that are entered into or structured with a principal purpose of avoiding the application of section 901(m).

#### IX. Miscellaneous

Proposed § 1.901(m)-8(b) provides that, when a foreign corporation becomes a section 902 corporation for the first time, as part of the required reconstruction of the U.S. tax history of the pre-1987 foreign income taxes of the foreign corporation, section 901(m) and these regulations must be applied to determine any disqualified tax amounts or aggregate basis difference carryovers that apply to the foreign corporation.

Proposed § 1.901(m)-8(c) provides an anti-abuse rule that applies to disregard an RFA with a built-in loss to the extent it relates to any asset acquisition structured with a principal purpose to use that RFA to avoid the application of section 901(m). This rule may apply, for example, if, with a principal purpose of avoiding the application of section 901(m), an asset is acquired in a transaction that preserves a built-in loss in the asset for U.S. income tax purposes but not for foreign income tax purposes.

#### X. Modifications to the Section 704(b) Regulations Related to Section 901(m)

Section 1.704-1(b)(4)(viii) provides a safe harbor under which allocations of creditable foreign tax expenditures (CFTEs) (as defined in § 1.704-1(b)(4)(viii)(b)) by a partnership to its partners are deemed to be in accordance with the partners' interests in the partnership. In general, the purpose of the safe harbor is to match allocations of CFTEs with the income to which the CFTEs relate. In order to apply the safe harbor, a partnership must (1) determine the partnership's “CFTE categories,” (2) determine the partnership's net income in each CFTE category, and (3) allocate the partnership's CFTEs to each category. In order to

satisfy the safe harbor, partnership allocations of CFTEs in a CFTE category must be proportionate to the allocations of the partnership's net income in the CFTE category.

A CFTE may be subject to section 901(m) because it is a foreign income tax amount that is paid or accrued by a partnership. Specifically, if a partnership owns an RFA with respect to a foreign income tax and that RFA has a basis difference subject to section 901(m), a portion of a foreign income tax amount paid or accrued by the partnership that relates to that foreign income tax may be disallowed as a foreign tax credit under section 901(m) in the hands of section 901(m) payors to whom the foreign income tax amount is allocated. The disqualified tax amount is determined by taking into account cost recovery amounts and disposition amounts with respect to the RFA that are allocated to those section 901(m) payors pursuant to the rules provided in proposed § 1.901(m)-5. In order to ensure that the proper portion of a foreign income tax amount paid or accrued by a partnership is disallowed under section 901(m), adjustments to the net income (and the allocations of that income) in a CFTE category that includes items attributable to the RFA are necessary in certain cases.

To illustrate such a case, assume a domestic entity that is a partnership for U.S. income tax purposes but a corporation for purposes of a foreign income tax (a hybrid partnership) is owned by partner A and partner B, each of which is a domestic entity that is a corporation for both U.S. and foreign income tax purposes. In this case, the hybrid partnership is the foreign payor and partners A and B are section 901(m) payors. The hybrid partnership is the RFA owner (U.S.) and the RFA owner (foreign) with respect to a single asset that is an RFA. Assume that in a given year the hybrid partnership has 110u of gross income for both U.S. and foreign tax purposes and a 10u depreciation deduction solely for U.S. income tax purposes, which gives rise to a cost recovery amount with respect to the RFA (as determined under proposed § 1.901(m)-5(b)(2)). All partnership items are allocated equally to partners A and B, except that the entire 10u U.S. depreciation deduction is allocated to partner A. Thus, partner A's dis-

tributive share of income is 45u (110u x 50%, less 10u) and partner B's distributive share of income is 55u (110u x 50%). Because the entire U.S. depreciation deduction is (or will be included) in partner A's distributive share of income for U.S. income tax purposes, the entire cost recovery amount that corresponds to the U.S. depreciation deduction of 10u is allocated to partner A. See proposed § 1.901(m)-5(d)(2). As a result, Partner A will take into account the 10u cost recovery amount in calculating a disqualified tax amount with respect to the portion of the relevant foreign income tax amount paid or accrued by the hybrid partnership and allocated to partner A under the CFTE allocation rules. In order to ensure that the portion of the foreign income tax amount paid or accrued by the hybrid partnership that is attributable to the 10u basis difference is properly subject to section 901(m), the U.S. depreciation deduction should not be taken into account under the CFTE allocation rules so that the portion of the foreign income tax amount attributable to the 10u basis difference is allocated to partner A. Accordingly, the net income of the CFTE category that includes the U.S. basis deduction should be increased by 10u (from 100u to 110u) to back out the portion of the U.S. depreciation deduction that corresponds to the cost recovery amount, and partner A's share of that net income should be increased by 10u (from 45u to 55u). In this example, as a result of the adjustment, the foreign income tax amount paid or accrued by the hybrid partnership will be allocated equally between partner A and partner B, because they each will have a 50-percent share of the net income in the CFTE category, as adjusted. Absent the adjustment, a portion of the foreign income tax amount attributable to the 10u basis difference would be allocated to partner B, a person that is not subject to section 901(m) (because no cost recovery amount is allocated to partner B).

No modification to the safe harbor is necessary to address cost recovery amounts and disposition amounts attributable to section 743(b) adjustments that are allocated to partners under proposed § 1.901(m)-5(e) (which applies when a section 901(m) payor acquires a partnership interest in a section 743(b) CAA), because, in

these cases, § 1.704-1T(b)(4)(viii)(c)(3) (i) already provides that the partnership determines net income in a CFTE category without regard to section 743(b) adjustments that its partners may have to the basis of property of the partnership. However, as discussed in section VI.D of the Explanation of Provisions section of this preamble, proposed § 1.901(m)-5(e) does not apply when another partnership (which by definition cannot be a section 901(m) payor) acquires a partnership interest in a section 743(b) CAA. Thus, modification to the safe harbor is necessary for all CAAs other than those section 743(b) CAAs described in proposed § 1.901(m)-5(e).

Accordingly, these proposed regulations add special rules under proposed § 1.704-1(b)(4)(viii)(c)(4)(v), (vi), and (vii) to address partnership items that give rise to cost recovery amounts and disposition amounts attributable to CAAs (other than section 743(b) CAAs described in proposed § 1.901(m)-5(e)). Specifically, these rules provide that, if an RFA has a positive basis difference, net income in a CFTE category that takes into account partnership items of income, deduction, gain, or loss attributable to the RFA (applicable CFTE category) is increased by the sum of the cost recovery amounts and disposition amounts attributable to U.S. disposition loss that correspond to those partnership items. Furthermore, to the extent a partner is allocated those cost recovery amounts or disposition amounts attributable to U.S. disposition loss, that partner's share of the net income in the CFTE category is increased by the same amount. Alternatively, if an RFA has a negative basis difference, the net income in the applicable CFTE category is decreased by the sum of the cost recovery amounts and disposition amounts attributable to U.S. disposition gain that correspond to partnership items in that CFTE category. Furthermore, to the extent a partner is allocated those cost recovery amounts or disposition amounts attributable to U.S. disposition gain, that partner's share of the net income in the CFTE category is decreased by the same amount.

## XI. Effective/Applicability Dates

These proposed regulations will apply to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers may, however, rely on the proposed regulations prior to the date the regulations are applicable provided that they both consistently apply proposed § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016 and consistently apply proposed § 1.901(m)-1 and §§ 1.901(m)-3 through 1.901(m)-8 (excluding § 1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

### Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply because the regulations do not impose a collection of information on small entities. Pursuant to section 7805(f), these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### 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 “Addresses.” The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request. 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 Jeffrey L. Parry of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS 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 is amended by adding entries in numerical order to read as follows:

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

Sections 1.901(m)-1 through -8 also issued under 26 U.S.C. 901(m)(7). \* \* \*

Section 1.901(m)-5 also issued under 26 U.S.C. 901(m)(3)(B)(ii). \* \* \*

Par. 2. Section 1.704-1, as proposed to be amended at 81 FR 5967, February 4, 2016, is further amended by adding two sentences at the end of paragraph (b)(1)(ii)(b)(I) and by adding paragraphs (b)(4)(viii)(c)(4)(v) through (b)(4)(viii)(c)(4)(vii) to read as follows:

§ 1.704-1 Partner's distributive share.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(b) \* \* \*

(I) \* \* \* Paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section apply to covered asset acquisitions (CAAs) (as defined in § 1.901(m)-1(a)(8)) occurring on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers may, however, rely on paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section prior to the date paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section are applicable provided that they consistently apply paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section, § 1.901(m)-1, and §§ 1.901(m)-3 through 1.901(m)-8 (excluding § 1.901(m)-4(e)) to all CAAs occurring on or after January

1, 2011, and consistently apply § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016.

\* \* \* \* \*

(4) \* \* \*

(viii) \* \* \*

(c) \* \* \*

(4) \* \* \*

(v) *Adjustments related to section 901(m)*. If one or more assets owned by a partnership are relevant foreign assets (or RFAs) with respect to a foreign income tax, then, solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(a)(I) of this section to allocations of CFTEs with respect to that foreign income tax, the net income in a CFTE category that includes partnership items of income, deduction, gain, or loss attributable to the RFA shall be increased by the amount described in paragraph (b)(4)(viii)(c)(4)(vi) of this section and reduced by the amount described in paragraph (b)(4)(viii)(c)(4)(vii) of this section. Similarly, a partner's CFTE category share of income shall be increased by the portion of the amount described in paragraph (b)(4)(viii)(c)(4)(vi) of this section that is allocated to the partner under § 1.901(m)-5(d) and reduced by the portion of the amount described in paragraph (b)(4)(viii)(c)(4)(vii) of this section that is allocated to the partner under § 1.901(m)-5(d). The principles of this paragraph (b)(4)(viii)(c)(4)(v) apply similarly when a partnership owns an RFA indirectly through one or more other partnerships. For purposes of paragraphs (b)(4)(viii)(c)(4)(v), (b)(4)(viii)(c)(4)(vi), and (b)(4)(viii)(c)(4)(vii) of this section, basis difference is defined in § 1.901(m)-4, cost recovery amount is defined in § 1.901(m)-5(b)(2), disposition amount is defined in § 1.901(m)-5(c)(2), foreign income tax is defined in § 1.901(m)-1(a)(21), RFA is defined in § 1.901(m)-2(c), U.S. disposition gain is defined in § 1.901(m)-1(a)(43), and U.S. disposition loss is defined in § 1.901(m)-1(a)(44).

(vi) *Adjustment amounts for RFAs with a positive basis difference*. With respect to RFAs with a positive basis difference, the amount referenced in (b)(4)(viii)(c)(4)(v) is the sum of any cost recovery amounts and disposition amounts attributable to U.S. disposition loss that correspond to partnership items that are included in the

net income in the CFTE category and that are taken into account for the U.S. taxable year of the partnership under § 1.901(m)-5(d).

(vii) *Adjustment amounts for RFAs with a negative basis difference.* With respect to RFAs with a negative basis difference, the amount referenced in (b)(4)(viii)(c)(4)(v) is the sum of any cost recovery amounts and disposition amounts attributable to U.S. disposition gain that correspond to partnership items that are included in the net income in the CFTE category and that are taken into account for the U.S. taxable year of the partnership under § 1.901(m)-5(d).

\* \* \* \* \*

Par. 3. Section 1.901(m)-1 is added to read as follows:

#### § 1.901(m)-1 Definitions.

(a) *Definitions.* [The text of proposed § 1.901(m)-1(a) is the same as the text of § 1.901(m)-1T(a) published elsewhere in this issue of the **Bulletin**.]

(1) The term *aggregate basis difference* means, with respect to a foreign income tax and a foreign payor, the sum of the allocated basis differences for a U.S. taxable year of a section 901(m) payor, plus any aggregate basis difference carryover from the immediately preceding U.S. taxable year of the section 901(m) payor with respect to the foreign income tax and foreign payor, as adjusted under § 1.901(m)-6(c). For purposes of this definition, if foreign law imposes tax on the combined income (within the meaning of § 1.901-2(f)(3)(ii)) of two or more foreign payors, all foreign payors whose items of income, deduction, gain, or loss are included in the U.S. taxable income or earnings and profits of the section 901(m) payor are treated as a single foreign payor. Aggregate basis difference is determined with respect to each separate category described in § 1.904-4(m).

(2) The term *aggregate basis difference carryover* has the meaning provided in § 1.901(m)-3(c).

(3) The term *aggregated CAA transaction* means a series of related CAAs occurring as part of a plan.

(4) The term *allocable foreign income* means the portion of foreign income of a foreign payor that relates to the foreign

income tax amount of the foreign payor that is paid or accrued by, or considered paid or accrued by, a section 901(m) payor.

(5) The term *allocated basis difference* means, with respect to an RFA and a foreign income tax, the sum of the cost recovery amounts and disposition amounts assigned to a U.S. taxable year of the section 901(m) payor under § 1.901(m)-5.

(6) through (8) [The text of proposed §§ 1.901(m)-1(a)(6) through (8) is the same as the text of §§ 1.901(m)-1T(a)(6) through (8) published elsewhere in this issue of the **Bulletin**.]

(9) The term *cumulative basis difference exemption* has the meaning provided in § 1.901(m)-7(b)(2).

(10) through (11) [The text of proposed §§ 1.901(m)-1(a)(10) through (11) is the same as the text of §§ 1.901(m)-1T(a)(10) through (11) published elsewhere in this issue of the **Bulletin**.]

(12) The term *disqualified tax amount* has the meaning provided in § 1.901(m)-3(b).

(13) through (14) [The text of proposed §§ 1.901(m)-1(a)(13) through (14) is the same as the text of §§ 1.901(m)-1T(a)(13) through (14) published elsewhere in this issue of the **Bulletin**.]

(15) The term *foreign basis* means the adjusted basis of an asset determined for purposes of a foreign income tax.

(16) The term *foreign basis election* has the meaning provided in § 1.901(m)-4(c).

(17) The term *foreign country creditable tax* (or *FCCT*) means, with respect to a foreign income tax amount, the amount of income, war profits, or excess profits tax paid or accrued to a foreign country or possession of the United States and claimed as a foreign tax credit for purposes of determining the foreign income tax amount. To qualify as a FCCT, the tax imposed by the foreign country or possession must be a foreign income tax or a withholding tax determined on a gross basis as described in section 901(k)(1)(B).

(18) through (21) [The text of proposed §§ 1.901(m)-1(a)(18) through (21) is the same as the text of §§ 1.901(m)-1T(a)(18) through (21) published elsewhere in this issue of the **Bulletin**.]

(22) The term *foreign income tax amount* means, with respect to a foreign

income tax, the amount of tax (including an amount of tax that is zero) reflected on a foreign tax return (as properly amended or adjusted). If foreign law imposes tax on the combined income (within the meaning of § 1.901-2(f)(3)(ii)) of two or more foreign payors, however, a foreign income tax amount means the amount of tax imposed on the combined income, regardless of whether the tax is reflected on a single foreign tax return. (23) The term *foreign payor* means an individual or entity (including a disregarded entity) subject to a foreign income tax. If a foreign income tax imposes tax on the combined income (within the meaning of § 1.901-2(f)(3)(ii)) of two or more individuals or entities, each such individual or entity is a foreign payor. An individual or entity may be a foreign payor with respect to more than one foreign income tax for purposes of applying section 901(m).

(24) The term *foreign taxable year* means a taxable year for purposes of a foreign income tax.

(25) The term *mid-year transaction* means a transaction in which a foreign payor that is a corporation or a disregarded entity has a change in ownership or makes an election pursuant to § 301.7701-3 to change its entity classification, or a transaction in which a foreign payor that is a partnership terminates under section 708(b)(1), provided in each case that the foreign payor's foreign taxable year does not close as a result of the transaction, and, if the foreign payor is a corporation or a partnership, the foreign payor's U.S. taxable year closes.

(26) through (28) [The text of proposed §§ 1.901(m)-1(a)(26) through (28) is the same as the text of §§ 1.901(m)-1T(a)(26) through (28) published elsewhere in this issue of the **Bulletin**.]

(29) The term *reverse hybrid* has the meaning provided in § 1.909-2(b)(1)(iv).

(30) The term *RFA class exemption* has the meaning provided in § 1.901(m)-7(b)(3).

(31) The term *RFA owner (U.S.)* means a person that owns an RFA for U.S. income tax purposes.

(32) The term *RFA owner (foreign)* means an individual or entity (including a disregarded entity) that owns an RFA for purposes of a foreign income tax.

(33) through (34) [The text of proposed §§ 1.901(m)-1(a)(33) through (34) is the same as the text of §§ 1.901(m)-1T(a)(33) through (34) published elsewhere in this issue of the **Bulletin**.]

(35) The term *section 901(m) payor* means a person eligible to claim the foreign tax credit allowed under section 901(a), regardless of whether the person chooses to claim the foreign tax credit, as well as a section 902 corporation (as defined in section 909(d)(5)). If members of a U.S. affiliated group of corporations (as defined in section 1504) file a consolidated return, each member is a separate section 901(m) payor. If individuals file a joint return, those individuals are treated as a single section 901(m) payor.

(36) through (38) [The text of proposed §§ 1.901(m)-1(a)(36) through (38) is the same as the text of §§ 1.901(m)-1T(a)(36) through (38) published elsewhere in this issue of the **Bulletin**.]

(39) The term *tentative disqualified tax amount* has the meaning provided in § 1.901(m)-3(b)(2).

(40) through (41) [The text of proposed §§ 1.901(m)-1(a)(40) through (41) is the same as the text of §§ 1.901(m)-1T(a)(40) through (41) published elsewhere in this issue of the **Bulletin**.]

(42) The term *U.S. basis deduction* has the meaning provided in § 1.901(m)-5(b)(3).

(43) through (45) [The text of proposed §§ 1.901(m)-1(a)(43) through (45) is the same as the text of §§ 1.901(m)-1T(a)(43) through (45) published elsewhere in this issue of the **Bulletin**.]

(b) *Effective/applicability date*. (1) Paragraphs (a)(1), (2), (3), (4), (5), (9), (12), (15), (16), (17), (22), (23), (24), (25), (29), (30), (31), (32), (35), (39), and (42) of this section apply to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(2) [The text of proposed § 1.901(m)-1(b)(2) is the same as the text of § 1.901(m)-1T(b)(2) published elsewhere in this issue of the **Bulletin**.]

(3) Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section, § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), and §§ 1.901(m)-3 through 1.901(m)-8 (excluding

§ 1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 4. Section 1.901(m)-2 is added to read as follows:

*§ 1.901(m)-2 Covered asset acquisitions and relevant foreign assets.*

(a) through (b)(3) [The text of proposed §§ 1.901(m)-2(a) through (b)(3) is the same as the text of §§ 1.901(m)-2T(a) through (b)(3) published elsewhere in this issue of the **Bulletin**.]

(4) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of U.S. income tax and as the acquisition of an interest in a fiscally transparent entity for purposes of a foreign income tax;

(5) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution of one or more assets the U.S. basis of which is determined by section 732(b) or 732(d) or which causes the U.S. basis of the partnership's remaining assets to be adjusted under section 734(b), provided the transaction results in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets; and

(6) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of both U.S. income tax and a foreign income tax, provided the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.

(c) *Relevant foreign asset*—(1) [The text of proposed § 1.901(m)-2(c)(1) is the same as the text of § 1.901(m)-2T(c)(1) published elsewhere in this issue of the **Bulletin**.]

(2) *RFA status with respect to a foreign income tax*. An asset is relevant in determining foreign income if income, deduc-

tion, gain, or loss attributable to the asset is taken into account in determining foreign income immediately after the CAA, or would be taken into account in determining foreign income immediately after the CAA if the asset were to give rise to income, deduction, gain, or loss at such time.

(3) *Subsequent RFA status with respect to another foreign income tax*. After a CAA, an asset will become an RFA with respect to another foreign income tax if, pursuant to a plan or series of related transactions that have a principal purpose of avoiding the application of section 901(m), an asset that was not relevant in determining foreign income for purposes of that foreign income tax immediately after the CAA becomes relevant in determining such foreign income. A principal purpose of avoiding section 901(m) will be deemed to exist if income, deduction, gain, or loss attributable to the asset is taken into account in determining such foreign income within the one-year period following the CAA, or would be taken into account in determining such foreign income during such time if the asset were to give rise to income, deduction, gain, or loss within the one-year period.

(d) [The text of proposed § 1.901(m)-2(d) is the same as the text of § 1.901(m)-2T(d) published elsewhere in this issue of the **Bulletin**.]

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

*Example 1. CAA involving an acquisition of a partnership interest for foreign income tax purposes*—(i) *Facts*. (A) FPS is an entity organized in Country F that is treated as a partnership for both U.S. and Country F income tax purposes. FPS is owned 50/50 by FC1 and FC2, each of which is a corporation organized in Country F and treated as a corporation for both U.S. and Country F income tax purposes. FPS has a single asset, Asset A. USP, a domestic corporation, owns all the interests in DE, a disregarded entity.

(B) Pursuant to the same transaction, USP acquires FC1's interest in FPS, and DE acquires FC2's interest in FPS. For U.S. income tax purposes, with respect to USP, the acquisition of the interests in FPS is treated as the acquisition of Asset A by USP. See Rev. Rul. 99-6, 1999-1 C.B. 432. For Country F tax purposes, the acquisitions of the interests of FPS by USP and DE are treated as acquisitions of partnership interests.

(ii) *Result*. The transaction is a CAA under paragraph (b)(4) of this section because it is treated as the acquisition of Asset A for U.S. income tax purposes and the acquisition of interests in a partnership for Country F tax purposes.

*Example 2. CAA involving an asset acquisition for purposes of both U.S. income tax and a foreign income tax—(i) Facts.* (A) USP, a domestic corporation, wholly owns CFC1, a foreign corporation, and CFC1 wholly owns CFC2, also a foreign corporation. CFC1 and CFC2 are organized in Country F. CFC1 owns Asset A.

(B) In an exchange described in section 351, CFC1 transfers Asset A to CFC2 in exchange for CFC2 common stock and cash. CFC1 recognizes gain on the exchange under section 351(b). Under section 362(a), CFC2's U.S. basis in Asset A is increased by the gain recognized by CFC1. For Country F tax purposes, gain or loss is not recognized on the transfer of Asset A to CFC2, and therefore there is no increase in the foreign basis in Asset A.

(ii) *Result.* The transaction is a CAA under paragraph (b)(6) of this section because it is treated as an acquisition of Asset A by CFC2 for both U.S. and Country F income tax purposes, and it results in an increase in the U.S. Basis of Asset A without a corresponding increase in the foreign basis of Asset A.

*Example 3. RFA status determined immediately after CAA; application of principal purpose rule—*

(i) *Facts.* (A) USP1 and USP2 are unrelated domestic corporations. USP1 wholly owns USSub, also a domestic corporation. On January 1 of Year 1, USP2 acquires all of the stock of USSub from USP1 in a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies. Immediately after the acquisition, none of the income, deduction, gain, or loss attributable to any of the assets of USSub is taken into account in determining foreign income for purposes of a foreign income tax nor would such items be taken into account in determining foreign income for purposes of a foreign income tax immediately after the acquisition if such assets were to give rise to income, deduction, gain, or loss immediately after the acquisition.

(B) On December 1 of Year 1, USSub contributes all its assets to FSub, its wholly owned subsidiary, which is a corporation for both U.S. and Country X income tax purposes, in a transfer described in section 351 (subsequent transfer). USSub recognizes no gain or loss for U.S. or Country X income tax purposes as a result of the subsequent transfer. As a result of the subsequent transfer, income, deduction, gain, or loss attributable to the assets of USSub that were transferred to FSub is taken into account in determining foreign income of FSub for Country X tax purposes.

(ii) *Result.* (A) Under paragraph (b)(1) of this section, the acquisition by USP2 of the stock of USSub is a section 338 CAA. Under paragraph (c)(1) of this section, none of the assets of USSub are RFAs immediately after the CAA, because none of the income, deduction, gain, or loss attributable to such assets is taken into account for purposes of determining foreign income with respect to any foreign income tax immediately after the CAA (nor would such items be taken into account for purposes of determining foreign income immediately after the CAA if such assets were to give rise to income, deduction, gain, or loss at such time).

(B) Although the subsequent transfer is not a CAA under paragraph (b) of this section, the subsequent transfer causes the assets of USSub to become

relevant in the hands of FSub in determining foreign income for Country X tax purposes. Because the subsequent transfer occurred within the one-year period following the CAA, it is presumed to have a principal purpose of avoiding section 901(m). Accordingly, under paragraph (c)(2) of this section, the assets of USSub with respect to the CAA occurring on January 1 of Year 1 become RFAs with respect to Country X tax as a result of the subsequent transfer. Thus, a basis difference with respect to Country X tax must be computed for the RFAs and taken into account under section 901(m).

(f) *Effective/applicability date.* (1) [The text of proposed § 1.901(m)-2(f)(1) is the same as the text of § 1.901(m)-2T(f)(1) published elsewhere in this issue of the **Bulletin**.]

(2) Paragraphs (b)(4) through (b)(6), (c)(2), (c)(3), and (e) of this section apply to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(3) Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section (excluding paragraph (d) of this section) to all CAAs occurring on or after December 7, 2016 and consistently apply § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)-1, and §§ 1.901(m)-3 through 1.901(m)-8 (excluding § 1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 5. Section 1.901(m)-3 is added to read as follows:

*§ 1.901(m)-3 Disqualified tax amount and aggregate basis difference carryover.*

(a) *In general.* If a section 901(m) payor has an aggregate basis difference, with respect to a foreign income tax and a foreign payor, for a U.S. taxable year, the section 901(m) payor must determine the portion of a foreign income tax amount that is disqualified under section 901(m) (disqualified tax amount). Paragraph (b) of this section provides rules for determining the disqualified tax amount. Paragraph (c) of this section provides rules for determining what portion, if any, of aggregate basis difference will be carried forward to the next U.S. taxable year (aggregated basis difference carryover).

Paragraph (d) of this section provides the effective/applicability date.

(b) *Disqualified tax amount—(1) In general.* A section 901(m) payor's disqualified tax amount is not taken into account in determining the credit allowed under section 901(a). If the section 901(m) payor is a section 902 corporation, the disqualified tax amount is not taken into account for purposes of section 902 or 960. Sections 78 and 275 do not apply to the disqualified tax amount. The disqualified tax amount is allowed as a deduction to the extent otherwise deductible (see sections 164, 212, and 964 and the regulations under those sections).

(2) *Determination of disqualified tax amount—(i) In general.* Except as provided in paragraph (b)(2)(iv) of this section, the disqualified tax amount is equal to the lesser of the foreign income tax amount that is paid or accrued by, or considered paid or accrued by, the section 901(m) payor for the U.S. taxable year or the tentative disqualified tax amount. All calculations are determined with respect to each separate category described in § 1.904-4(m).

(ii) *Tentative disqualified tax amount.* The tentative disqualified tax amount is equal to the amount determined under paragraph (b)(2)(ii)(A) of this section reduced (but not below zero) by the amount described in paragraph (b)(2)(ii)(B) of this section.

(A) The product of—

(1) The sum of the foreign income tax amount and the FCCTs that are paid or accrued by, or considered paid or accrued by, the section 901(m) payor, and

(2) A fraction, the numerator of which is the aggregate basis difference, but not in excess of the allocable foreign income, and the denominator of which is the allocable foreign income.

(B) The amount of the FCCT that is a disqualified tax amount of the section 901(m) payor with respect to another foreign income tax.

(iii) *Allocable foreign income—(A) No allocation required.* Except as provided in paragraph (b)(2)(iii)(D) of this section, if the entire foreign income tax amount is paid or accrued by, or considered paid or accrued by, a single section 901(m) payor, then the allocable foreign income is equal to the entire foreign income, determined

with respect to each separate category described in § 1.904–4(m).

(B) *Allocation required.* Except as provided in paragraph (b)(2)(iii)(D) of this section, if the foreign income tax amount is allocated to, and considered paid or accrued by, more than one person, a section 901(m) payor's allocable foreign income is equal to the portion of the foreign income that relates to the foreign income tax amount allocated to that section 901(m) payor, determined with respect to each separate category described in § 1.904–4(m).

(C) *Rules for allocations.* This paragraph (b)(2)(iii)(C) provides allocation rules that apply to determine allocable foreign income in certain cases.

(I) If the foreign payor is involved in a mid-year transaction and the foreign income tax amount is allocated under § 1.336–2(g)(3)(ii), 1.338–9(d), or 1.901–2(f)(4), then, to the extent any portion of the foreign income tax amount is allocated to, and considered paid or accrued by, a section 901(m) payor, the allocable foreign income of the section 901(m) payor is determined in accordance with the principles of § 1.1502–76(b). To the extent the foreign income tax amount is allocated to an entity that is a partnership for U.S. income tax purposes, a portion of the foreign income is first allocated to the partnership in accordance with the principles of § 1.1502–76(b), which is then allocated under the rules of paragraph (b)(2)(iii)(C)(2) of this section to determine the allocable foreign income of a section 901(m) payor that owns an interest in the partnership directly or indirectly through one or more other partnerships for U.S. income tax purposes.

(2) If the foreign income tax amount is considered paid or accrued by a section 901(m) payor for a U.S. taxable year under § 1.702–1(a)(6), the determination of the allocable foreign income must be consistent with the allocation of the foreign income tax amount that relates to the foreign income. See § 1.704–1(b)(4)(viii).

(3) If the foreign income tax amount that is allocated to, and considered paid or accrued by, a section 901(m) payor for a U.S. taxable year is determined under § 1.901–2(f)(3)(i), the allocable foreign income is determined in accordance with § 1.901–2(f)(3)(iii).

(D) *Failure to substantiate allocable foreign income.* If, pursuant to section 901(m)(3)(A), a section 901(m) payor fails to substantiate its allocable foreign income to the satisfaction of the Secretary, then allocable foreign income will equal the amount determined by dividing the sum of the foreign income tax amount and the FCCTs that are paid or accrued by, or considered paid or accrued by, the section 901(m) payor, by the highest marginal tax rate applicable to income of the foreign payor under foreign tax law.

(iv) *Special rule.* A section 901(m) payor's disqualified tax amount is zero for a U.S. taxable year if:

(A) The section 901(m) payor's aggregate basis difference for the U.S. taxable year is a negative amount;

(B) Foreign income is less than or equal to zero for the foreign taxable year of the foreign payor; or

(C) The foreign income tax amount that is paid or accrued by, or considered paid or accrued by, the section 901(m) payor for the U.S. taxable year is zero.

(3) *Examples.* The following examples illustrate the rules of paragraph (b)(2) of this section. For purposes of all the examples, unless otherwise specified: USP is a domestic corporation. CFC1, CFC2, DE1, and DE2 are organized in Country F and are treated as corporations for Country F tax purposes. CFC1 and CFC2 are section 902 corporations (as defined in section 909(d)(5)). DE1 and DE2 are disregarded entities. USP, CFC1, and CFC2 have a calendar year for both U.S. and Country F income tax purposes, and DE1 and DE2 have a calendar year for Country F tax purposes. Country F and Country G each impose a single tax that is a foreign income tax. CFC1, CFC2, DE1, and DE2 each have a functional currency of the U with respect to all activities. At all relevant times, 1u equals \$1. All amounts are stated in millions. The examples assume that the applicable cost recovery method for property results in basis being recovered ratably over the life of the property beginning on the first day of the U.S. taxable year in which the property is acquired or placed into service; there is a single § 1.904–4(m) separate category with respect to a foreign income and foreign income tax amount; and a section 901(m) payor properly substantiates its

allocable foreign income to the satisfaction of the Secretary.

*Example 1. Determining aggregate basis difference; multiple foreign payors—(i) Facts.* CFC1 wholly owns CFC2 and DE1. DE1 wholly owns DE2. Assume that the tax laws of Country F do not allow combined income reporting or the filing of consolidated income tax returns. Accordingly, CFC1, CFC2, DE1, and DE2 file separate tax returns for Country F tax purposes. USP acquires all of the stock of CFC1 in a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies for both CFC1 and CFC2.

(ii) *Result.* (A) The acquisition of CFC1 gives rise to four separate CAAs under § 1.901(m)–2(b). The acquisition of the stock of CFC1 and the deemed acquisition of the stock of CFC2 under section 338(h)(3)(B) is each a Section 338 CAA under § 1.901(m)–2(b)(1). Furthermore, because the deemed acquisition of the assets of DE1 and DE2 for U.S. income tax purposes is disregarded for Country F tax purposes, each acquisition is a CAA under § 1.901(m)–2(b)(2). Because these four CAAs occur pursuant to a plan, under § 1.901(m)–1(a)(3) they are part of an aggregated CAA transaction. Under § 1.901(m)–1(a)(31), CFC1 is the RFA owner (U.S.) with respect to its assets and those of DE1 and DE2. CFC2 is the RFA owner (U.S.) with respect to its assets. Under § 1.901(m)–1(a)(23), CFC1, CFC2, DE1, and DE2 are each a foreign payor for Country F tax purposes. Under § 1.901(m)–1(a)(35), CFC1 is the section 901(m) payor with respect to foreign income tax amounts for which CFC1, DE1, and DE2 are the foreign payors (see §§ 1.901–2(f)(1) and 1.901–2(f)(4)(ii)). CFC2 is the section 901(m) payor with respect to foreign income tax amounts for which CFC2 is the foreign payor (see § 1.901–2(f)(1)).

(B) In determining aggregate basis difference under § 1.901(m)–1(a)(1) for a U.S. taxable year of CFC1, CFC1 has three computations with respect to Country F tax, because there are three foreign payors for Country F tax purposes whose foreign income tax amount, if any, is considered paid or accrued by CFC1 as the section 901(m) payor. Furthermore, for each U.S. taxable year, CFC1 will compute a separate disqualified tax amount and aggregate basis difference Carryover (if any) under paragraph (b)(2) of this section, with respect to each foreign payor.

(C) In determining aggregate basis difference for a U.S. taxable year of CFC2 under § 1.901(m)–1(a)(1), CFC2 has a single computation with respect to Country F tax, because there is a single foreign payor (CFC2) for Country F tax purposes whose foreign income tax amount, if any, is considered paid or accrued by CFC2 as the section 901(m) payor. Furthermore, for each U.S. taxable year, CFC2 will compute a disqualified tax amount and aggregate basis difference Carryover (if any) under paragraph (b)(2) of this section.

(iii) *Alternative facts.* Assume the same facts as in paragraph (i) of this Example 1, except that foreign income for Country F tax purposes is based on combined income (within the meaning of § 1.901–2(f)(3)(ii)) of CFC1, CFC2, DE1, and DE2. For purposes of determining an aggregate basis difference for a U.S. taxable year of CFC1 under § 1.901(m)–1(a)(1), CFC1, DE1, and DE2 are

treated as a single foreign payor because all of the items of income, deduction, gain, or loss with respect to CFC1, DE1, and DE2 are included in the earnings and profits of CFC1 for U.S. income tax purposes. For each U.S. taxable year, CFC1 will therefore compute a single aggregate basis difference, disqualified tax amount, and aggregate basis difference carryover. The result for CFC2 under the alternative facts is the same as in paragraph (ii)(C) of this Example 1.

*Example 2. Computation of disqualified tax amount—(i) Facts.* On December 31 of Year 0, USP acquires all of the stock of CFC1 in a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (Acquisition). CFC1 owns four assets (Asset A, Asset B, Asset C, and Asset D, and collectively, Assets) and conducts activities in Country F and in a Country G branch. The activities conducted by CFC1 in Country G are not subject to tax in Country F. The tax rate is 25% in Country F and 30% in Country G. For Country F tax purposes,

CFC1's foreign income and foreign income tax amount for each foreign taxable year 1 through 15 is 100u and \$25 (25u translated at the exchange rate of \$1 = 1u), respectively. For Country G tax purposes, CFC1's foreign income and foreign income tax amount for each foreign taxable year 1 through 5 is 400u and \$120 (120u translated at the exchange rate of \$1 = 1u), respectively. No dispositions occur for any of the Assets during the applicable cost recovery period. Additional facts relevant to each of the Assets are summarized below.

Assets	Relevant foreign income tax	Basis Difference	Applicable Cost Recovery Period	Cost Recovery Amount
Asset A	Country F tax	150u	15 years	10u (150u/15)
Asset B	Country F tax	50u	5 years	10u (50u/5)
Asset C	Country G tax	300u	5 years	60u (300u/5)
Asset D	Country G tax	(100u)	5 years	negative 20u (negative 100/5)

(ii) *Result.* (A) Under § 1.901(m)-2(b)(1), the Acquisition of the stock of CFC1 is a Section 338 CAA. Under § 1.901(m)-2(c)(1), Assets A and B are RFAs with respect to Country F tax, because they are relevant in determining foreign income of CFC1 for Country F tax purposes and were owned by CFC1 when the Acquisition occurred. Assets C and D are RFAs with respect to Country G tax, because they are relevant in determining foreign income of CFC1 for Country G tax purposes and were owned by CFC1 when the Acquisition occurred. Under § 1.901(m)-1(a)(31), CFC1 is the RFA owner (U.S.) with respect to all of the RFAs. Under § 1.901(m)-1(a)(35) and (a)(23), CFC1 is the section 901(m) payor and the foreign payor for Country F and Country G tax purposes.

(B) In determining aggregate basis difference for a U.S. taxable year of CFC1, CFC1 has two computations, one with respect to Country F tax and one with respect to Country G tax. Under § 1.901(m)-1(a)(1), the aggregate basis difference for a U.S. taxable year with respect to Country F tax is equal to the sum of the allocated basis differences with respect to Assets A and B for the U.S. taxable year. Under § 1.901(m)-1(a)(5), allocated basis differences are comprised of cost recovery amounts and disposition amounts. Because there are no dispositions, the only allocated basis differences taken into account in determining an aggregate basis difference are cost recovery amounts. Under § 1.901(m)-5(b), any cost recovery amounts are attributed to CFC1, because CFC1 is the section 901(m) payor and RFA owner (U.S.) with respect to all of the Assets. For each U.S. taxable year, CFC1 will compute a separate disqualified tax amount and aggregate basis difference carryover (if any) with respect to Country F tax and Country G tax under paragraph (b)(2) of this section. For purposes of both disqualified tax amount computations, because CFC1 is the section 901(m) payor and foreign payor, the foreign income tax amount paid or accrued by CFC1 with respect to Country F tax and Country G tax, respectively, will be the entire foreign income tax amount and CFC1's allocable foreign income will be the entire foreign income.

(C) With respect to Country F tax, in U.S. taxable years 1 through 5, CFC1 has an aggregate basis difference of 20u each year (10u cost recovery amount with respect to Asset A plus 10u cost recovery amount with respect to Asset B). For U.S. taxable years 1 through 5, under paragraph (b)(2) of this section, the disqualified tax amount each year is \$5, the lesser of two amounts: the tentative disqualified tax amount, in this case, \$5 (\$25 foreign income tax amount x (20u aggregate basis difference/100u allocable foreign income)), or the foreign income tax amount paid or accrued by CFC1, in this case, \$25. After U.S. taxable year 5, Asset B has no unallocated basis difference with respect to Country F tax. Accordingly, in U.S. taxable years 6 through 15, CFC1 has an aggregate basis difference of 10u each year. Accordingly, for U.S. taxable years 6 through 15, the disqualified tax amount each year is \$2.50, the lesser of two amounts: the tentative disqualified tax amount, in this case, \$2.50 (\$25 foreign income tax amount x (10u aggregate basis difference/100u allocable foreign income)), or the foreign income tax amount paid or accrued by CFC1, in this case, \$25. After U.S. taxable year 15, Asset A has no unallocated basis difference with respect to Country F tax and, therefore, CFC1 has no disqualified tax amount with respect to Country F tax.

(D) With respect to Country G tax, in U.S. taxable years 1 through 5, CFC1 has an aggregate basis difference of 40u each year (60u cost recovery amount with respect to Asset C + (20u) cost recovery amount with respect to Asset D). For U.S. taxable years 1 through 5, under paragraph (b)(2) of this section, the disqualified tax amount each year is \$12, the lesser of two amounts: the tentative disqualified tax amount, in this case, \$12 (\$120 foreign income tax amount x (40u aggregate basis difference/400u allocable foreign income)), or the foreign income tax amount paid or accrued by CFC1, in this case, \$120. After U.S. taxable year 5, Asset C and Asset D have no unallocated basis difference with respect to Country G tax. Accordingly, in U.S. taxable years 6 through 15, CFC1 has no disqualified tax amount with respect to Country G tax.

*Example 3. FCCT—(i) Facts.* In U.S. taxable year 1, USP acquires all of the interests in DE1 in a

transaction (Transaction) that is treated as a stock acquisition for Country F tax purposes. Immediately after the Transaction, DE1 owns assets (Pre-Transaction Assets), all of which are used in a Country G branch and give rise to income that is taken into account for Country F tax and Country G tax purposes. After the Transaction, DE1 acquires additional assets (Post-Transaction Assets), which are not used by the Country G branch. Both Country F and Country G have a tax rate of 30%. Country F imposes worldwide tax on its residents and provides a foreign tax credit for taxes paid to other jurisdictions. In foreign taxable year 3, 100u of income is attributable to DE1's Post-Transaction Assets and 100u of income is attributable to DE1's Pre-Transaction Assets. For Country G tax purposes, the foreign income is 100u and foreign income tax amount is 30u (30% x 100u). For Country F tax purposes, the foreign income is 200u and the pre-foreign tax credit tax is 60u (30% x 200u). The 60u of Country F pre-foreign tax credit tax is reduced by the 30u foreign income tax amount imposed for Country G tax purposes. Thus, the foreign income tax amount for Country F tax purposes is \$30 (30u translated into dollars at the exchange rate of \$1 = 1u). Assume that for U.S. taxable year 3 USP has 100u aggregate basis difference with respect to Country F tax and 100u aggregate basis difference with respect to Country G tax. USP does not dispose of DE1 or any assets of DE1 in U.S. taxable year 3.

(ii) *Result.* (A) Under § 1.901(m)-2(b)(2), the Transaction is a CAA. Under § 1.901(m)-2(c)(1), the Pre-Transaction Assets are RFAs with respect to both Country F tax and Country G tax, because they are relevant in determining the foreign income of DE1 for Country F tax and Country G tax purposes and were owned by DE1 when the Transaction occurred. Under § 1.901(m)-1(a)(31), USP is the RFA owner (U.S.) with respect to the RFAs. Under § 1.901(m)-1(a)(23), DE1 is a foreign payor for Country F tax and Country G tax purposes. Under § 1.901(m)-1(a)(35), USP is the section 901(m) payor with respect to foreign income tax amounts for which DE1 is the foreign payor (see § 1.901-2(f)(4)(ii)). Because the Country G foreign income tax amount is claimed as a credit for purposes of

determining the Country F foreign income tax amount, the Country G foreign income tax amount is an FCCT under § 1.901(m)-1(a)(17).

(B) Under § 1.901(m)-1(a)(1), for each U.S. taxable year, USP will separately compute the aggregate basis difference with respect to Country F tax and with respect to Country G tax, and will use those amounts to separately compute a disqualified tax amount and aggregate basis difference carryover (if any) with respect to each foreign income tax. Because DE1 is a disregarded entity owned by USP during the entire U.S. taxable year 3, the foreign income tax amount paid or accrued by DE1 is not subject to allocation. Accordingly, for purposes of each of the disqualified tax amount computations, the foreign income tax amount paid or accrued by USP with respect to Country F tax and Country G tax, respectively, is the entire foreign income tax amount paid or accrued by DE1, and, under paragraph (b)(2)(iii)(A) of this section, USP's allocable foreign income will be equal to DE1's entire foreign income.

(C) As stated in paragraph (i) of this *Example 3*, for U.S. taxable year 3 USP has 100u aggregate basis difference with respect to Country F tax and 100u aggregate basis difference with respect to Country G tax. With respect to Country G tax, in U.S. taxable year 3, under paragraph (b)(2) of this section, the disqualified tax amount is \$30, the lesser of the two amounts: the tentative disqualified tax amount, in this case, \$30 (\$30 foreign income tax amount x (100u aggregate basis difference/100u allocable foreign income)), or the foreign income tax amount considered paid or accrued by USP, in this case, \$30.

(D) With respect to Country F tax, in U.S. taxable year 3, under paragraph (b)(2) of this section, the disqualified tax amount is \$0, the lesser of two amounts: the tentative disqualified tax amount, in this case \$0 ((\$30 foreign income tax amount + \$30 Country G FCCT) x (100u aggregate basis difference/200u foreign income) = \$30 reduced by \$30 Country G FCCT that is a disqualified tax amount of USP), or the foreign income tax amount considered paid or accrued by USP, in this case, \$30.

(c) *Aggregate basis difference carryover*—(1) *In general*. If a section 901(m) payor has an aggregate basis difference carryover for a U.S. taxable year, as determined under this paragraph (c), the aggregate basis difference carryover is taken into account in computing the section 901(m) payor's aggregate basis difference for the next U.S. taxable year. For successor rules that apply to an aggregate basis difference carryover, see § 1.901(m)-6(c).

(2) *Amount of aggregate basis difference carryover*. (i) If a section 901(m) payor's disqualified tax amount is zero, all of the section 901(m) payor's aggregate basis difference (positive or negative) for the U.S. taxable year gives rise to an aggregate basis difference carryover to the next U.S. taxable year.

(ii) If a section 901(m) payor's disqualified tax amount is not zero, then aggregate basis difference carryover can arise in either or both of the following two situations:

(A) If a section 901(m) payor's aggregate basis difference for the U.S. taxable year exceeds its allocable foreign income, the excess gives rise to an aggregate basis difference carryover.

(B) If the tentative disqualified tax amount exceeds the disqualified tax amount, the excess tentative disqualified tax amount is converted into aggregate basis difference carryover by multiplying such excess by a fraction, the numerator of which is the allocable foreign income, and the denominator of which is the sum of the foreign income tax amount and the FCCTs that are paid or accrued by, or considered paid or accrued by, the section 901(m) payor.

(3) *Example*. The following example illustrates the rule of paragraph (c) of this section.

*Example. Aggregate basis difference carryover; section 901(m) payor's U.S. taxable year differs from the foreign taxable year of foreign payor*—(i) *Facts*. (A) On July 1 of Year 1, CFC1 acquires all of the interests of DE1 in a transaction (Transaction) that is treated as a stock acquisition for Country F tax purposes. CFC1 and DE1 are organized in Country F and are treated as corporations for Country F tax purposes. CFC1 is a section 902 corporation (as defined in section 909(d)(5)), and DE1 is a disregarded entity. CFC1 has a calendar year for U.S. income tax purposes, and DE1 has a June 30 year-end for Country F tax purposes. Country F imposes a single tax that is a foreign income tax. CFC1 and DE1 each have a functional currency of the u with respect to all activities. Immediately after the Transaction, DE1 owns one asset, Asset A, that gives rise to income that is taken into account for Country F tax purposes. For the first U.S. taxable year (U.S. taxable year 1) there is a cost recovery amount with respect to Asset A of 9u, and for each subsequent U.S. taxable year until the U.S. basis is fully recovered, there is a cost recovery amount with respect to Asset A of 18u. There is no disposition of Asset A.

(ii) *Result*. (A) Under § 1.901(m)-2(b)(2), the Transaction is a CAA. Under § 1.901(m)-2(c)(1), Asset A is an RFA with respect to Country F tax because it is relevant in determining the foreign income of DE1 for Country F tax purposes and was owned by DE1 when the Transaction occurred. Under § 1.901(m)-1(a)(31), CFC1 is the RFA owner (U.S.) with respect to Asset A. Under § 1.901(m)-1(a)(23), DE1 is a foreign payor for Country F tax purposes. Under § 1.901(m)-1(a)(35), CFC1 is the section 901(m) payor with respect to foreign income tax amounts for which DE1 is the foreign payor (see § 1.901-2(f)(4)(ii)).

(B) Under § 1.901(m)-1(a)(1), in determining the aggregate basis difference for U.S. taxable year 1, CFC1 has one computation with respect to Country F tax. Under § 1.901(m)-1(a)(1), aggregate basis difference with respect to Country F tax is equal to the sum of allocated basis differences with respect to all RFAs, which, in this case, is only Asset A. Under § 1.901(m)-1(a)(5), allocated basis differences are comprised of cost recovery amounts and disposition amounts. Because there is no disposition of Asset A, the only allocated basis difference taken into account in determining an aggregate basis difference are cost recovery amounts with respect to Asset A. Under § 1.901(m)-5(b), any cost recovery amounts are assigned to a U.S. taxable year of CFC1, because CFC1 is the section 901(m) payor and RFA owner (U.S.) with respect to Asset A. Under paragraph (b)(2) of this section, for each U.S. taxable year, CFC1 will compute a disqualified tax amount and aggregate basis difference carryover with respect to the aggregate basis difference. Because DE1 is a disregarded entity owned by CFC1, the foreign income tax amount paid or accrued by DE1 is not subject to allocation. Accordingly, for purposes of the disqualified tax amount computation, the foreign income tax amount paid or accrued by CFC1 with respect to Country F tax is the entire foreign income tax amount paid or accrued by DE1, and under paragraph (b)(2)(iii)(A) of this section, CFC1's allocable foreign income will be equal to DE1's entire foreign income.

(C) In U.S. taxable year 1, CFC1 has an aggregate basis difference of 9u (the 9u cost recovery amount with respect to Asset A for U.S. taxable year 1). However, because the foreign taxable year of DE1, the foreign payor, will not end between July 1 and December 31, there will not be a foreign income tax amount for U.S. taxable year 1. Because the foreign income tax amount considered paid or accrued by CFC1 for U.S. taxable year 1 is zero, under paragraph (b)(2)(iv) of this section, the disqualified tax amount for U.S. taxable year 1 of CFC1 is also zero. Furthermore, because the disqualified tax amount is zero, under paragraph (c)(2)(i) of this section, CFC1 has an aggregate basis difference carryover equal to 9u, the entire amount of the aggregate basis difference for U.S. taxable year 1. Under paragraph (c)(1) of this section, the 9u aggregate basis difference carryover is taken into account in computing CFC1's aggregate basis difference for U.S. taxable year 2. Accordingly, in U.S. taxable year 2, CFC1 has an aggregate basis difference of 27u (18u cost recovery amount for U.S. taxable year 2, plus 9u aggregate basis difference carryover from U.S. taxable year 1).

(d) *Effective/applicability date*. This section applies to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section, § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)-1, and §§ 1.901(m)-4 through 1.901(m)-8 (excluding

§ 1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 6. Section 1.901(m)-4 is added to read as follows:

*§ 1.901(m)-4 Determination of basis difference.*

(a) through (b) [The text of proposed §§ 1.901(m)-4(a) through (b) is the same as the text of §§ 1.901(m)-4T(a) through (b) published elsewhere in this issue of the **Bulletin**.]

(c) *Foreign basis election.* (1) An election (foreign basis election) may be made to apply section 901(m)(3)(C)(i)(II) by reference to the foreign basis immediately after the CAA instead of the U.S. basis immediately before the CAA. Accordingly, if a foreign basis election is made, basis difference is the U.S. basis in the RFA immediately after the CAA, less the foreign basis in the RFA immediately after the CAA. For this purpose, the foreign basis immediately after the CAA takes into account any adjustment to that foreign basis resulting from the CAA for purposes of the foreign income tax.

(2) Except as otherwise provided in this paragraph (c), a foreign basis election is made by the RFA owner (U.S.). If, however, the RFA owner (U.S.) is a partnership, each partner in the partnership (and not the partnership) may independently make a foreign basis election. In the case of one or more tiered partnerships, the foreign basis election is made at the level at which a partner is not also a partnership.

(3) The election may be made separately for each CAA, and with respect to each foreign income tax and each foreign payor. For purposes of making the foreign basis election, all CAAs that are part of an aggregated CAA transaction are treated as a single CAA. Furthermore, for purposes of making the foreign basis election, if foreign law imposes tax on the combined income (within the meaning of § 1.901-2(f)(3)(ii)) of two or more foreign payors, all foreign payors whose items of income,

deduction, gain, or loss for U.S. income tax purposes are included in the U.S. taxable income or earnings and profits of a single section 901(m) payor are treated as a single foreign payor.

(4) A foreign basis election is made by using foreign basis to determine basis difference for purposes of computing a disallowed tax amount and an aggregate basis difference carryover for the U.S. taxable year, as provided under § 1.901(m)-3. A separate statement or form evidencing the foreign basis election need not be filed. Except as provided in paragraph (c)(5) and (6) of this section, in order for a foreign basis election to be effective, the election must be reflected on a timely filed original federal income tax return (including extensions) for the first U.S. taxable year that the foreign basis election is relevant to the computation of any amounts reported on such return, including on any required schedules.

(5) If the RFA owner (U.S.) is a partnership, a foreign basis election reflected on a partner's timely filed amended federal income tax return is also effective if all of the following conditions are satisfied:

(i) The partner's timely filed original federal income tax return (including extensions) for the first U.S. taxable year of the partner in which a foreign basis election is relevant to the computation of any amounts reported on such return, including on any required schedules, does not reflect the application of section 901(m);

(ii) The information provided by the partnership to the partner for purposes of applying section 901(m) and any information required to be reported by the partnership is based solely on computations that use foreign basis to determine basis difference; and

(iii) Prior to the due date of the original federal income tax return (including extensions) described in paragraph (c)(5)(i) of this section, the partner delegated the authority to the partnership to choose whether to provide the partner with information to apply section 901(m) using foreign basis, either pursuant to a written partnership agreement (within the meaning of § 1.704-1(b)(2)(ii)(h)) or written notice provided by the partner to the partnership.

(6) If, pursuant to paragraph (g)(3) of this section, a taxpayer chooses to have this section apply to CAAs occurring on or after January 1, 2011, a foreign basis election will be effective if the election is reflected on a timely filed amended federal income tax return (or tax returns, as applicable) filed no later than one year following the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(7) The foreign basis election is irrevocable. Relief under § 301.9100-1 is not available for the foreign basis election.

(d) *Determination of basis difference in a section 743(b) CAA*—(1) [The text of proposed § 1.901(m)-4(d)(1) is the same as the text of § 1.901(m)-4T(d)(1) published elsewhere in this issue of the **Bulletin**.]

(2) *Foreign basis election.* If a foreign basis election is made with respect to a section 743(b) CAA, then, for purposes of paragraph (d)(1) of this section, the section 743(b) adjustment is determined by reference to the foreign basis of the RFA, determined immediately after the CAA.

(e) [The text of proposed § 1.901(m)-4(e) is the same as the text of § 1.901(m)-4T(e) published elsewhere in this issue of the **Bulletin**.]

(f) *Examples.* The following examples illustrate the rules of this section:

*Example 1. Scope of basis choice; identifying separate CAAs, RFA owners (U.S.), and foreign payors in an aggregated CAA transaction*—(i) *Facts.* CFC1 wholly owns CFC2, both of which are section 902 corporations (as defined in section 909(d)(5)), organized in Country F, and treated as corporations for Country F tax purposes. CFC1 also wholly owns DE1, and DE1 wholly owns DE2. DE1 and DE2 are entities organized in Country F treated as corporations for Country F tax purposes and as disregarded entities for U.S. income tax purposes. Country F imposes a single tax that is a foreign income tax. All of the stock of CFC1 is acquired in a qualified stock purchase (within the meaning of section 338(d)(3)) to which section 338(a) applies for both CFC1 and CFC2. For Country F tax purposes, the transaction is treated as an acquisition of the stock of CFC1.

(ii) *Result.* (A) The acquisition of CFC1 gives rise to four separate CAAs described in § 1.901(m)-2. Under § 1.901(m)-2(b)(1), the acquisition of the stock of CFC1 and the deemed acquisition of the stock of CFC2 under section 338(h)(3)(B) are each a section 338 CAA. Furthermore, because the deemed acquisition of the assets of each of DE1 and DE2 for U.S. income tax purposes is disregarded for Country F tax purposes, the deemed acquisitions are CAAs under § 1.901(m)-2(b)(2). Because the four CAAs occurred pursuant to a plan, under § 1.901(m)-1(a)(3), all of the CAAs

are part of an aggregated CAA transaction. Under § 1.901(m)-1(a)(31), CFC1 is the RFA owner (U.S.) with respect to its assets and the assets of DE1 and DE2 that are RFAs. CFC2 is the RFA owner (U.S.) with respect to its assets that are RFAs. Under § 1.901(m)-1(a)(23), CFC1, CFC2, DE1, and DE2 are each a foreign payor for Country F tax purposes.

(B) Under paragraph (c) of this section, a foreign basis election may be made by the RFA owner (U.S.). The election is made separately with respect to each CAA (for this purpose, treating all CAAs that are part of an aggregated CAA transaction as a single CAA) and with respect to each foreign income tax and foreign payor. Thus, in this case, CFC1 can make a separate foreign basis election for one or more of the following three groups of RFAs: RFAs that are relevant in determining foreign income of CFC1; RFAs that are relevant in determining foreign income of DE1; and RFAs that are relevant in determining foreign income of DE2. Furthermore, CFC2 can make a foreign basis election for all of its RFAs that are relevant in determining its foreign income.

*Example 2. Scope of basis choice; RFA owner (U.S.) is a partnership—(i) Facts.* USPS is a domestic partnership for which a section 754 election is in effect. USPS owns two assets, the stock of DE1 and DE2. DE1 is an entity organized in Country X and treated as a corporation for Country X tax purposes. DE2 is an entity organized in Country Y and treated as a corporation for Country Y tax purposes. DE1 and DE2 are disregarded entities. Country X and Country Y each impose a single tax that is a foreign income tax. US1 and US2, unrelated domestic corporations, and FP, a foreign person unrelated to US1 and US2, acquire partnership interests in USPS from existing partners of USPS pursuant to the same plan.

(ii) *Result.* Under § 1.901(m)-2(b)(3), the acquisitions of the partnership interests in USPS by US1, US2, and FP each give rise to separate section 743(b) CAAs, but under § 1.901(m)-1(a)(3), they are treated as an aggregated CAA transaction because they occur as part of a plan. Under § 1.901(m)-1(a)(31), USPS is the RFA owner (U.S.) with respect to the assets of DE1 and DE2 that are RFAs. Under § 1.901(m)-1(a)(23), DE1 is a foreign payor for Country X tax purposes and DE2 is a foreign payor for Country Y tax purposes. Because the RFA owner (U.S.) is a partnership, paragraph (c)(2) of this section provides that US1, US2, and FP (the relevant partners in USPS) separately choose whether to make a foreign basis election for purposes of determining basis difference. Furthermore, under paragraph (c)(3) of this section, the choice to make the election is made separately by each partner with respect to each foreign payor. Thus, in this case, each partner may make separate elections for the RFAs that are relevant in determining foreign income of DE1 for Country X tax purposes and the RFAs that are relevant in determining foreign income of DE2 for Country Y tax purposes.

(g) *Effective/applicability date—(1)* [The text of proposed § 1.901(m)-4(g)(1) is the same as the text of § 1.901(m)-4T(g)(1) published elsewhere in this issue of the **Bulletin**.]

(2) Except for paragraphs (a), (b), (d)(1), and (e) of this section, this section applies to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(3) Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section (excluding paragraph (e) of this section), § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)-1, § 1.901(m)-3, and §§ 1.901(m)-5 through 1.901(m)-8 to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 7. Section 1.901(m)-5 is added to read as follows:

*§ 1.901(m)-5 Basis difference taken into account.*

(a) *In general.* This section provides rules for determining the amount of basis difference with respect to an RFA that is taken into account in a U.S. taxable year for purposes of determining the disqualified portion of a foreign income tax amount. Paragraph (b) of this section provides rules for determining a cost recovery amount and assigning that amount to a U.S. taxable year of a single section 901(m) payor when the RFA owner (U.S.) is the section 901(m) payor. Paragraph (c) of this section provides rules for determining a disposition amount and assigning that amount to a U.S. taxable year of a single section 901(m) payor when the RFA owner (U.S.) is the section 901(m) payor. Paragraph (d) of this section provides rules for allocating cost recovery amounts and disposition amounts when the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes. Paragraph (e) of this section provides special rules for allocating cost recovery amounts and disposition amounts with respect to certain section 743(b) CAAs. Paragraph (f) of this section provides special rules for allocating certain disposition amounts when a foreign payor is transferred in a mid-year transaction.

Paragraph (g) of this section provides special rules for allocating both cost recovery amounts and disposition amounts in certain cases in which the RFA owner (U.S.) either is a reverse hybrid or a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid. Paragraph (h) of this section provides examples illustrating the application of this section. Paragraph (i) of this section provides the effective/applicability date.

(b) *Basis difference taken into account under applicable cost recovery method—*

(1) *In general.* When the RFA owner (U.S.) is a section 901(m) payor, all of a cost recovery amount is attributed to the section 901(m) payor and assigned to the U.S. taxable year of the section 901(m) payor in which the corresponding U.S. basis deduction is taken into account under the applicable cost recovery method. This is the case regardless of whether the deduction is deferred or disallowed for U.S. income tax purposes. If instead the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes, a cost recovery amount is allocated to one or more section 901(m) payors under paragraph (d) of this section, except as provided in paragraphs (e) and (g) of this section. If a cost recovery amount arises from an RFA with respect to a section 743(b) CAA, in certain cases the cost recovery amount is allocated to a section 901(m) payor under paragraph (e) of this section. In certain cases in which the RFA owner (U.S.) either is a reverse hybrid or a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid, a cost recovery amount is allocated to one or more section 901(m) payors under paragraph (g) of this section.

(2) *Determining a cost recovery amount—*  
(i) [The text of proposed § 1.901(m)-5(b)(2)(i) is the same as the text of § 1.901(m)-5T(b)(2)(i) published elsewhere in this issue of the **Bulletin**.]

(ii) *U.S. basis subject to multiple cost recovery methods.* If the entire U.S. basis is not subject to the same cost recovery method, the applicable cost recovery method for determining the cost recovery amount is the cost recovery method that applies to the portion of the

U.S. basis that corresponds to the basis difference.

(3) *Applicable cost recovery method.* For purposes of section 901(m), an applicable cost recovery method includes any method for recovering the cost of property over time for U.S. income tax purposes (each application of a method giving rise to a “U.S. basis deduction”). Such methods include depreciation, amortization, or depletion, as well as a method that allows the cost (or a portion of the cost) of property to be expensed in the year of acquisition or in the placed-in-service year, such as under section 179. Applicable cost recovery methods do not include any provision allowing the U.S. basis to be recovered upon a disposition of an RFA.

(c) *Basis difference taken into account as a result of a disposition—(1) In general.* Except as provided in paragraph (f) of this section, when the RFA owner (U.S.) is a section 901(m) payor, all of a disposition amount is attributed to the section 901(m) payor and assigned to the U.S. taxable year of the section 901(m) payor in which the disposition occurs. If instead the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes, except as provided in paragraphs (e), (f), and (g) of this section, a disposition amount is allocated to one or more section 901(m) payors under paragraph (d) of this section. If a disposition amount arises from an RFA with respect to a section 743(b) CAA, in certain cases the disposition amount is allocated to a section 901(m) payor under paragraph (e) of this section. If there is a disposition of an RFA in a foreign taxable year of a foreign payor during which there is a mid-year transaction, in certain cases a disposition amount is allocated under paragraph (f) of this section. In certain cases in which the RFA owner (U.S.) either is a reverse hybrid or a fiscally transparent entity for both U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid, a disposition amount is allocated to one or more section 901(m) payors under paragraph (g) of this section.

(2) [The text of proposed § 1.901(m)-5(c)(2) is the same as the text of § 1.901(m)-5T(c)(2) published elsewhere in this issue of the **Bulletin**.]

(d) *General rules for allocating and assigning a cost recovery amount or a*

*disposition amount when the RFA owner (U.S.) is a fiscally transparent entity—(1) In general.* Except as provided in paragraphs (e), (f), and (g) of this section, this paragraph (d) provides rules for allocating a cost recovery amount or a disposition amount when the RFA owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes in which a section 901(m) payor directly or indirectly owns an interest, as well as for assigning the allocated amount to a U.S. taxable year of the section 901(m) payor. For purposes of this paragraph (d), unless otherwise indicated, a reference to direct or indirect ownership in an entity means for U.S. income tax purposes. For purposes of this paragraph (d), a person indirectly owns an interest in an entity for U.S. income tax purposes if the person owns the interest through one or more fiscally transparent entities for U.S. income tax purposes, and at least one of the fiscally transparent entities is not a disregarded entity. For purposes of this paragraph (d), a person indirectly owns an interest in an entity for foreign income tax purposes if the person owns the interest through one or more fiscally transparent entities for foreign income tax purposes. If the RFA owner (U.S.) is a lower-tier fiscally transparent entity for U.S. income tax purposes in which the section 901(m) payor indirectly owns an interest, the rules of this section apply in a manner consistent with the application of these rules when the section 901(m) payor directly owns an interest in the RFA owner (U.S.).

(2) *Allocation of a cost recovery amount.* A cost recovery amount is allocated to a section 901(m) payor that directly or indirectly owns an interest in the RFA owner (U.S.) to the extent the U.S. basis deduction that corresponds to the cost recovery amount is (or will be) included in the section 901(m) payor’s distributive share of the income of the RFA owner (U.S.) for U.S. income tax purposes.

(3) *Allocation of a disposition amount attributable to foreign disposition gain or foreign disposition loss—(i) In general.* Except as provided in paragraph (f) of this section, a disposition amount attributable to foreign disposition gain or foreign disposition loss (as determined under paragraph (d)(5) of this section) is allocated under paragraph (d)(3)(ii) or (d)(3)(iii) of

this section to a section 901(m) payor that directly or indirectly owns an interest in the RFA owner (U.S.).

(ii) *First allocation rule.* This paragraph (d)(3)(ii) applies when a section 901(m) payor, or a disregarded entity directly owned by a section 901(m) payor, is the foreign payor whose foreign income includes a distributive share of the foreign income of the RFA owner (foreign) and, therefore, all of the foreign income tax amount of the foreign payor is paid or accrued by, or considered paid by, the section 901(m) payor. Thus, this paragraph (d)(3)(ii) applies when the RFA owner (U.S.) is a fiscally transparent entity for both U.S. and foreign income tax purposes and a section 901(m) payor either directly owns an interest in the RFA owner (U.S.) or directly owns an interest in another fiscally transparent entity for U.S. and foreign income tax purposes, which, in turn, directly or indirectly owns an interest in the RFA owner (U.S.) for both U.S. and foreign income tax purposes. In these cases, the section 901(m) payor is allocated the portion of a disposition amount that is equal to the product of the disposition amount attributable to foreign disposition gain or foreign disposition loss, as applicable, and a fraction, the numerator of which is the portion of the foreign disposition gain or foreign disposition loss recognized by the RFA owner (foreign) for foreign income tax purposes that is (or will be) included in the foreign payor’s distributive share of the foreign income of the RFA owner (foreign), and the denominator of which is the foreign disposition gain or foreign disposition loss.

(iii) *Second allocation rule.* This paragraph (d)(3)(iii) applies when neither a section 901(m) payor nor a disregarded entity directly owned by a section 901(m) payor is the foreign payor with respect to the foreign income of the RFA owner (foreign). Instead, a section 901(m) payor directly or indirectly owns an interest in the foreign payor, which is a fiscally transparent entity for U.S. income tax purposes (other than a disregarded entity directly owned by the section 901(m) payor), and, therefore, the section 901(m) payor is considered to pay or accrue only its allocated portion of the foreign income tax amount of the foreign payor. This will be the case

when the foreign payor is either the RFA owner (U.S.), another fiscally transparent entity for U.S. income tax purposes (other than a disregarded entity directly owned by a section 901(m) payor) that directly or indirectly owns an interest in the RFA owner (U.S.) for both U.S. and foreign income tax purposes, or a disregarded entity directly owned by the RFA owner (U.S.). In these cases, the section 901(m) payor is allocated the portion of a disposition amount that is equal to the product of the disposition amount attributable to foreign disposition gain or foreign disposition loss, as applicable, and a fraction, the numerator of which is the portion of the foreign disposition gain or foreign disposition loss that is included in the allocable foreign income of the section 901(m) payor, and the denominator of which is the foreign disposition gain or foreign disposition loss. If allocable foreign income is not otherwise required to be determined because there is no foreign income tax amount, the numerator is the portion of the foreign disposition gain or foreign disposition loss that would be included in the allocable foreign income of the section 901(m) payor if there were a foreign income tax amount.

(4) *Allocation of a disposition amount attributable to U.S. disposition gain or U.S. disposition loss.* A section 901(m) payor that directly or indirectly owns an interest in the RFA owner (U.S.) is allocated the portion of a disposition amount that is equal to the product of the disposition amount attributable to U.S. disposition gain or U.S. disposition loss (as determined under paragraph (d)(5) of this section), as applicable, and a fraction, the numerator of which is the portion of the U.S. disposition gain or U.S. disposition loss that is (or will be) included in the section 901(m) payor's distributive share of income of the RFA owner (U.S.) for U.S. income tax purposes, and the denominator of which is the U.S. disposition gain or U.S. disposition loss.

(5) *Determining the extent to which a disposition amount is attributable to foreign or U.S. disposition gain or loss—(i) RFA with a positive basis difference.* When there is a disposition of an RFA with a positive basis difference and the disposition results in either a foreign disposition gain or a U.S. disposition loss,

but not both, the entire disposition amount is attributable to foreign disposition gain or U.S. disposition loss, as applicable, even if the disposition amount exceeds the foreign disposition gain or the absolute value of the U.S. disposition loss. If the disposition results in both a foreign disposition gain and a U.S. disposition loss, the disposition amount is attributable first to foreign disposition gain to the extent thereof, and the excess disposition amount, if any, is attributable to the U.S. disposition loss, even if the excess disposition amount exceeds the absolute value of the U.S. disposition loss.

(ii) *RFA with a negative basis difference.* When there is a disposition of an RFA with a negative basis difference and the disposition results in either a foreign disposition loss or a U.S. disposition gain, but not both, the entire disposition amount is attributable to foreign disposition loss or U.S. disposition gain, as applicable, even if the absolute value of the disposition amount exceeds the absolute value of the foreign disposition loss or the U.S. disposition gain. If the disposition results in both a foreign disposition loss and a U.S. disposition gain, the disposition amount is attributable first to foreign disposition loss to the extent thereof, and the excess disposition amount, if any, is attributable to the U.S. disposition gain, even if the absolute value of the excess disposition amount exceeds the U.S. disposition gain.

(6) *U.S. taxable year of a section 901(m) payor to which an allocated cost recovery amount or disposition amount is assigned.* A cost recovery amount or a disposition amount allocated to a section 901(m) payor under paragraph (d) of this section is assigned to the U.S. taxable year of the section 901(m) payor that includes the last day of the U.S. taxable year of the RFA owner (U.S.) in which, in the case of a cost recovery amount, the RFA owner (U.S.) takes into account the corresponding U.S. basis deduction (without regard to whether the deduction is deferred or disallowed for U.S. income tax purposes), or in the case of a disposition amount, the disposition occurs.

(e) *Special rules for certain section 743(b) CAAs.* If a section 901(m) payor acquires a partnership interest in a section 743(b) CAA, including a section 743(b)

CAA with respect to a lower-tier partnership that results from a direct acquisition by the section 901(m) payor of an interest in an upper-tier partnership, and subsequently there is a cost recovery amount or a disposition amount that arises from an RFA with respect to that section 743(b) CAA, all of the cost recovery amount or the disposition amount is allocated to that section 901(m) payor. The U.S. taxable year of the section 901(m) payor to which the cost recovery amount or the disposition amount is assigned is the U.S. taxable year in which, in the case of a cost recovery amount, the section 901(m) payor takes into account the corresponding U.S. basis deduction (without regard to whether the deduction is deferred or disallowed for U.S. income tax purposes), or in the case of a disposition amount, the disposition occurs.

(f) *Mid-year transactions—(1) In general.* When a disposition of an RFA occurs in the same foreign taxable year that a foreign payor is involved in a mid-year transaction, the portion of the disposition amount that is attributable to foreign disposition gain or foreign disposition loss (as determined under paragraph (d)(5) of this section) is allocated to a section 901(m) payor and assigned to a U.S. taxable year of the section 901(m) payor under this paragraph (f). To the extent the disposition amount is attributable to U.S. disposition gain or U.S. disposition loss (as determined under paragraph (d)(5) of this section), see paragraph (c)(1) or (d) of this section, as applicable.

(2) *Allocation rule.* To the extent a disposition amount is attributable to foreign disposition gain or foreign disposition loss, a section 901(m) payor is allocated the portion of the disposition amount equal to the product of the disposition amount attributable to foreign disposition gain or foreign disposition loss, as applicable, and a fraction, the numerator of which is the portion of the foreign disposition gain or foreign disposition loss that is included in the allocable foreign income of the section 901(m) payor, and the denominator of which is the foreign disposition gain or foreign disposition loss. If allocable foreign income is not otherwise required to be determined because there is no foreign income tax amount, the numerator is the portion of

the foreign disposition gain or foreign disposition loss that would be included in the allocable foreign income of the section 901(m) payor if there were a foreign income tax amount.

(3) *Assignment to a U.S. taxable year of a section 901(m) Payor.* A disposition amount allocated to a section 901(m) payor under paragraph (f)(2) of this section is assigned to the U.S. taxable year of the section 901(m) payor in which the foreign disposition gain or foreign disposition loss (or portion thereof) is included in allocable foreign income of the section 901(m) payor or, if allocable foreign income is not otherwise required to be determined because there is no foreign income tax amount, the U.S. taxable year in which the foreign disposition gain or foreign disposition loss would be included in allocable foreign income if there were a foreign income tax amount.

(g) *Reverse hybrids*—(1) *In general.* This paragraph (g) provides rules for allocating a cost recovery amount or a disposition amount when the RFA owner (U.S.) is either a reverse hybrid or a fiscally transparent entity for U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid for U.S. and foreign income tax purposes, and in each case, the foreign payor whose foreign income includes a distributive share of the foreign income of the RFA owner (foreign) directly or indirectly owns an interest in the reverse hybrid for foreign income tax purposes. Application of the allocation rules under paragraphs (g)(2) and (g)(3) of this section depend upon whether a section 901(m) payor or a disregarded entity directly owned by a section 901(m) payor is the foreign payor, or, instead, a section 901(m) payor directly or indirectly owns an interest in the foreign payor. For purposes of this paragraph (g), unless otherwise indicated, a reference to direct or indirect ownership in an entity means for U.S. income tax purposes. For purposes of this paragraph (g), a person indirectly owns an interest in an entity for U.S. income tax purposes if the person owns the interest through one or more fiscally transparent entities for U.S. income tax purposes, and at least one of the fiscally transparent entities is not a disregarded entity. For purposes of this paragraph (g), a person indirectly owns an

interest in an entity for foreign income tax purposes if the person owns the interest through one or more fiscally transparent entities for foreign income tax purposes. If the RFA owner (U.S.) is a lower-tier fiscally transparent entity for U.S. income tax purposes in which the reverse hybrid indirectly owns an interest, the rules of this section apply in a manner consistent with the application of these rules when the reverse hybrid directly owns an interest in the RFA owner (U.S.).

(2) *First allocation rule*—(i) *Allocation to a section 901(m) payor.* This paragraph (g)(2)(i) applies when a section 901(m) payor, or a disregarded entity directly owned by a section 901(m) payor, is the foreign payor whose foreign income includes a distributive share of the foreign income of the RFA owner (foreign), and, therefore, all of the foreign income tax amount of the foreign payor is paid or accrued by, or considered paid or accrued by, the section 901(m) payor. Thus, this paragraph (g)(2)(i) applies when a section 901(m) payor either directly owns an interest in the reverse hybrid or directly owns an interest in a fiscally transparent entity for U.S. and foreign income tax purposes, which, in turn, directly or indirectly owns an interest in the reverse hybrid for both U.S. and foreign income tax purposes. In these cases, the section 901(m) payor is allocated the portions of cost recovery amounts or disposition amounts (or both) with respect to RFAs that are equal to the product of the sum of the cost recovery amounts and the disposition amounts and a fraction, the numerator of which is the portion of the foreign income of the RFA owner (foreign) that is included in the foreign income of the foreign payor, and the denominator of which is the foreign income of the RFA owner (foreign).

(ii) *Assignment to a U.S. taxable year of a section 901(m) Payor.* This paragraph (g)(2)(ii) applies when a cost recovery amount or a disposition amount, or portion thereof, is allocated to a section 901(m) payor under paragraph (g)(2)(i) of this section. If the reverse hybrid is the RFA owner (U.S.), a cost recovery amount or disposition amount, or portion thereof, is assigned to the U.S. taxable year of the section 901(m) payor that includes the last day of the U.S. taxable year

of the reverse hybrid in which, in the case of a cost recovery amount, the reverse hybrid takes into account the corresponding U.S. basis deduction (without regard to whether the deduction is deferred or disallowed for U.S. income tax purposes), or, in the case of a disposition amount, the disposition occurs. If the reverse hybrid is not the RFA owner (U.S.) but instead the reverse hybrid directly or indirectly owns an interest in the RFA owner (U.S.) for both U.S. and foreign income tax purposes, a cost recovery amount or disposition amount, or portion thereof, is assigned to the U.S. taxable year of the section 901(m) payor that includes the last day of the U.S. taxable year of the reverse hybrid, which, in turn, includes the last day of the U.S. taxable year of the RFA owner (U.S.) in which, in the case of a cost recovery amount, the RFA owner (U.S.) takes into account the corresponding U.S. basis deduction (without regard to whether the deduction is deferred or disallowed for U.S. income tax purposes), or, in the case of a disposition amount, the disposition occurs.

(3) *Second allocation rule*—(i) *Allocation to a section 901(m) payor.* This paragraph (g)(3)(i) applies when neither a section 901(m) payor nor a disregarded entity directly owned by a section 901(m) payor is the foreign payor with respect to the foreign income of the RFA owner (foreign). Instead, a section 901(m) payor directly or indirectly owns an interest in the foreign payor, which is a fiscally transparent entity for U.S. income tax purposes (other than a disregarded entity directly owned by the section 901(m) payor), and, therefore, the section 901(m) payor is considered to pay or accrue only its allocated portion of the foreign income tax amount of the foreign payor. In these cases, the section 901(m) payor is allocated the portions of cost recovery amounts or disposition amounts (or both) with respect to RFAs that are equal to the product of the sum of the cost recovery amounts and the disposition amounts and a fraction, the numerator of which is the portion of the foreign income of the RFA owner (foreign) that is included in the foreign income of the foreign payor and included in the allocable foreign income of the section 901(m) payor, and the denominator of which is the foreign income of the RFA

owner (foreign). If allocable foreign income is not otherwise required to be determined for a section 901(m) payor because there is no foreign income tax amount, the numerator is the foreign income of the RFA owner (foreign) that is included in the foreign income of the foreign payor and that would be included in allocable foreign income of the section 901(m) payor if there were a foreign income tax amount.

(ii) *Assignment to a U.S. taxable year of a section 901(m) payor.* A cost recovery amount or a disposition amount, or portion thereof, that is allocated to a section 901(m) payor under paragraph (g)(3)(i) of this section is assigned to the U.S. taxable year of the section 901(m) payor in which the foreign income of the RFA owner (foreign) described in paragraph (g)(3)(i) of this section is included in the allocable foreign income of the section 901(m) payor, or, if there is no foreign income tax amount, the U.S. taxable year of the section 901(m) payor in which the foreign income of the RFA owner (foreign) described in paragraph (g)(3)(i) of this section would be included in allocable foreign income if there were a foreign income tax amount.

(h) *Examples.* The following examples illustrate the rules of this section. In addition to any facts described in a particular example, the following facts apply to all the examples unless otherwise specified: CFC1, CFC2, and DE are organized in Country F and treated as corporations for Country F tax purposes. CFC1 and CFC2 are each a section 902 corporation (as defined in section 909(d)(5)) that is wholly owned by the same U.S. corporation, and DE is a disregarded entity. CFC1 and CFC2 have a U.S. taxable year that is a calendar year, and CFC1, CFC2, and DE have a foreign taxable year that is a calendar year. Country F imposes a single tax that is a foreign income tax. CFC1, CFC2, and DE each have a functional currency of the u with respect to all activities. At all relevant times, 1u equals \$1. All amounts are stated in millions. The examples assume that the applicable cost recovery method for property results in basis being recovered ratably over the life of the property beginning on the first day of the U.S. taxable year in which the property is acquired or placed into service.

*Example 1. CAA followed by disposition: fully taxable for both U.S. income tax and foreign income tax purposes—(i) Facts.* (A) On January 1, Year 1, USP acquires all of the stock of CFC1 in a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (Section 338 Acquisition). At the time of the Section 338 Acquisition, CFC1 owns a single asset (Asset A) that is located in Country F. Asset A gives rise to income that is taken into account for Country F tax purposes. Asset A is tangible personal property that, under the applicable cost recovery method in the hands of CFC1, is depreciable over 5 years. There are no cost recovery deductions available for Country F tax purposes with respect to Asset A. Immediately before the Section 338 Acquisition, Asset A has a U.S. basis of 10u and a foreign basis of 40u. Immediately after the Section 338 Acquisition, Asset A has a U.S. basis of 100u and a foreign basis of 40u.

(B) On July 1, Year 2, Asset A is transferred to an unrelated third party in exchange for 120u in a transaction in which all realized gain is recognized for both U.S. income tax and Country F tax purposes (subsequent transaction). For U.S. income tax purposes, CFC1 recognizes U.S. disposition gain of 50u (amount realized of 120u, less U.S. basis of 70u (100u cost basis, less 30u of accumulated depreciation)) with respect to Asset A. The 30u of accumulated depreciation is the sum of 20u of depreciation in Year 1 (100u cost basis/5 years) and 10u of depreciation in Year 2 ((100u cost basis/5 years) x 6/12). For Country F tax purposes, CFC1 recognizes foreign disposition gain of 80u (amount realized of 120u, less foreign basis of 40u) with respect to Asset A. Immediately after the subsequent transaction, Asset A has a U.S. basis and a foreign basis of 120u.

(ii) *Result.* (A) Under § 1.901(m)–2(b)(1), USP's acquisition of the stock of CFC1 in the Section 338 Acquisition is a section 338 CAA. Under § 1.901(m)–2(c)(i), Asset A is an RFA with respect to Country F tax because it is relevant in determining the foreign income of CFC1 for Country F tax purposes. Under § 1.901(m)–4(b), the basis difference with respect to Asset A is 90u (100u – 10u). Under Section 901(m)–1(a)(31), CFC1 is the RFA owner (U.S.) with respect to Asset A. Under § 1.901(m)–1(a)(23), CFC1 is a foreign payor for Country F tax purposes. Under § 1.901(m)–1(a)(35), CFC1 is the section 901(m) payor with respect to a foreign income tax amount for which CFC1 is the foreign payor (see § 1.901–2(f)(1)).

(B) Under § 1.901(m)–1(a)(5), allocated basis differences are comprised of cost recovery amounts and disposition amounts. In Year 1, Asset A has an allocated basis difference that includes only a cost recovery amount. Under paragraph (b)(2) of this section, the cost recovery amount for Year 1 is determined by applying the applicable cost recovery method of Asset A in the hands of CFC1 to the basis difference with respect to Asset A. Accordingly the cost recovery amount is 18u (90u basis difference/5 years). Under paragraph (b)(1) of this section, all of the 18u cost recovery amount is attributed to CFC1 and assigned to Year 1, because CFC1 is a section 901(m) payor and RFA owner (U.S.) with respect to Asset A and Year 1 is the U.S. taxable year of CFC1 in which it takes into account the corresponding 20u of depreciation. Immediately after Year 1, under

§ 1.901(m)–1(a)(40), unallocated basis difference is 72u with respect to Asset A (90u – 18u).

(C) In Year 2, Asset A has an allocated basis difference that includes both a cost recovery amount and a disposition amount. Under paragraph (b)(2) of this section, the cost recovery amount for Year 2, as of the date of the subsequent transaction, is 9u ((90u basis difference/5 years) x 6/12). Under § 1.901(m)–1(a)(10), the subsequent transaction is a disposition of Asset A, because the subsequent transaction is an event that results in an amount of gain being recognized for U.S. income tax and Country F tax purposes. Because all realized gain in Asset A is recognized for U.S. income tax and Country F tax purposes, the rule in paragraph (c)(2)(i) of this section applies to determine the disposition amount. Under that rule, the disposition amount for Year 2 is the unallocated basis difference of 63u (90u basis difference, less total 27u taken into account as cost recovery amounts in Year 1 and Year 2). Accordingly, the allocated basis difference for Year 2 is 72u (9u of cost recovery amount, plus 63u of disposition amount). Under paragraphs (b)(1) and (c)(1) of this section, all of the 72u of allocated basis difference is attributed to CFC1 and assigned to Year 2, because CFC1 is a section 901(m) payor and the RFA owner (U.S.) with respect to Asset A and Year 2 is the U.S. taxable year of CFC1 in which it takes into account the corresponding 10u of depreciation and in which the disposition occurred.

(D) Unallocated basis difference with respect to Asset A, as determined immediately after the subsequent transaction, is 0u (90u basis difference less 90u basis difference taken into account as 27u total cost recovery amount in Year 1 and Year 2 and as a 63u disposition amount in Year 2). Accordingly, because there is no unallocated basis difference with respect to Asset A attributable to the Section 338 Acquisition, the subsequent transaction is not a successor transaction as defined in § 1.901(m)–6(b)(2). Furthermore, the subsequent transaction is not a CAA under § 1.901(m)–2(b). For these reasons, section 901(m) no longer applies to Asset A.

*Example 2. CAA followed by Disposition: non-taxable for U.S. income tax purposes and taxable for foreign income tax purposes—(i) Facts.* The facts are the same as in paragraph (i)(A) of *Example 1* but the facts in paragraph (i)(B) of *Example 1* are instead that on July 1, Year 2, Asset A is transferred to CFC2, in exchange for 100u of stock of CFC2 (subsequent transaction). For U.S. income tax purposes, CFC1 does not recognize any U.S. disposition gain or U.S. disposition loss with respect to Asset A. For Country F tax purposes, CFC1 recognizes foreign disposition gain of 60u (amount realized of 100u, less foreign basis of 40u) with respect to Asset A. Immediately after the subsequent transaction, Asset A has a U.S. basis of 70u (100u cost basis less 30u accumulated depreciation) and a foreign basis of 100u. The 30u of accumulated depreciation is the sum of 20u of depreciation in Year 1 (100u cost basis/5 years) and 10u in Year 2 ((100u cost basis/5 years) x 6/12).

(ii) *Result.* (A) The results described in paragraph (ii)(A) of *Example 1* also apply to this *Example 2*.

(B) The result for Year 1 is the same as in paragraph (ii)(B) of *Example 1*.

(C) In Year 2, Asset A has an allocated basis difference that includes both a cost recovery amount and a disposition amount. Under paragraph (b)(2) of this section, the cost recovery amount for Year 2, as of the date of the subsequent transaction, is 9u ((90u basis difference/5 years) x 6/12). Under § 1.901(m)-1(a)(10), the Transaction is a disposition of Asset A, because the subsequent transaction is an event that results in an amount of gain being recognized for Country F tax purposes. Because the disposition is not also fully taxable for U.S. income tax purposes, the rule in paragraph (c)(2)(ii) of this section applies to determine the disposition amount. Under that rule, the disposition amount is 60u, the lesser of (i) 60u (60u foreign disposition gain plus absolute value of 0u U.S. disposition loss), and (ii) 63u unallocated basis difference (90 basis difference less total 27u taken into account as cost recovery amounts, 18u in Year 1 and 9u in Year 2). Accordingly, the allocated basis difference for the first half of Year 2 is 69u (9u of cost recovery amount, plus 60u of disposition amount). Under paragraphs (b)(1) and (c)(1) of this section, all of the 69u of allocated basis difference is attributed to CFC1 and assigned to Year 2, because CFC1 is a section 901(m) payor and the RFA owner (U.S.) with respect to Asset A and Year 2 is the U.S. taxable year of CFC1 in which it takes into account the corresponding 10u of depreciation and in which the disposition occurred.

(D) Unallocated basis difference with respect to Asset A immediately after the subsequent transaction is 3u (90u basis difference less 87u basis difference taken into account as a 27u total cost recovery amount in Year 1 and Year 2 and as a 60u disposition amount in Year 2). Accordingly, because there is unallocated basis difference of 3u with respect to Asset A attributable to the Section 338 Acquisition, as determined immediately after the subsequent transaction, the subsequent transaction is a successor transaction as defined in § 1.901(m)-6(b)(2). Following the subsequent transaction, the unallocated basis difference of 3u must be taken into account as cost recovery amounts or disposition amounts (or both) by CFC2, the new section 901(m) payor and RFA owner (U.S.) of Asset A. See § 1.901(m)-6(b)(3)(ii). Because the subsequent transaction is not a CAA under § 1.901(m)-2(b), there is no additional basis difference with respect to Asset A as a result of the subsequent transaction.

*Example 3. CAA followed by disposition: non-taxable for both U.S. income tax and foreign income tax purposes—(i) Facts.* The facts are the same as in paragraph (i)(A) of *Example 1* but the facts in paragraph (i)(B) of *Example 1* are instead that on July 1, Year 2, CFC1 transfers Asset A to CFC2, in exchange for 110u of stock of CFC2 (subsequent transaction). For U.S. income tax purposes, CFC1 does not recognize any U.S. disposition gain or U.S. disposition loss with respect to Asset A as a result of the subsequent transaction. Furthermore, for Country F tax purposes, CFC1 recognizes no foreign disposition gain or foreign disposition loss with respect to Asset A as a result of the subsequent transaction. Immediately after the subsequent transaction, Asset A has a U.S. basis of 70u (100u cost basis less 30u accumulated depreciation) and a foreign basis of 40u. The 30u of accumulated depreciation is the sum of 20u of depreciation in Year 1 (100u cost basis/5

years) and 10u in Year 2 ((100u cost basis/5 years) x 6/12).

(ii) *Result.* (A) The result for Year 1 is the same as in paragraph (ii)(A) of *Example 1*.

(B) The result for Year 1 is the same as in paragraph (ii)(B) of *Example 1*.

(C) In Year 2, Asset A has an allocated basis difference that includes only a cost recovery amount. Under paragraph (b)(2) of this section, the cost recovery amount for Year 2, as of the date of the subsequent transaction, is 9u ((90u basis difference/5 years) x 6/12). Under § 1.901(m)-1(a)(10), the subsequent transaction does not constitute a disposition of Asset A, because the subsequent transaction is not an event that results in an amount of gain or loss being recognized for U.S. income tax or for Country F tax purposes. Therefore, no disposition amount is taken into account for Asset A in Year 2. Under paragraph (b)(1) of this section, all of the 9u of allocated basis difference is attributed to CFC1 and assigned to Year 2, because CFC1 is a section 901(m) payor and RFA owner (U.S.) with respect to Asset A and Year 2 is the U.S. taxable year of CFC1 in which it takes into account the corresponding 10u of depreciation.

(D) Unallocated basis difference with respect to Asset A immediately after the subsequent transaction is 63u (90u basis difference, less 27u total cost recovery amounts, 18u in Year 1 and 9u in Year 2). Accordingly, because there is unallocated basis difference of 63u with respect to Asset A attributable to the CAA, as determined immediately after the subsequent transaction, the subsequent transaction is a successor transaction as defined in § 1.901(m)-6(b)(2). Following the subsequent transaction, the unallocated basis difference of 63u must be taken into account as cost recovery amounts or disposition amounts (or both) by CFC2, the new section 901(m) payor and RFA owner (U.S.) of Asset A. See § 1.901(m)-6(b)(3)(ii). Because the subsequent transaction is not a CAA under § 1.901(m)-2(b), there is no additional basis difference with respect to Asset A as a result of the subsequent transaction.

(i) *Effective/applicability date.* (1) Except for paragraphs (b)(2)(i) and (c)(2) of this section, this section applies to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(2) [The text of proposed § 1.901(m)-5(i)(2) is the same as the text of § 1.901(m)-5T(i)(2) published elsewhere in this issue of the **Bulletin**.]

(3) Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section, § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)-1, § 1.901(m)-3, § 1.901(m)-4 (excluding § 1.901(m)-4(e)), § 1.901(m)-6, § 1.901(m)-7, and § 1.901(m)-8 to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding

§ 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 8. Section 1.901(m)-6 is added to read as follows:

#### § 1.901(m)-6 Successor rules.

(a) through (b)(2) [The text of proposed §§ 1.901(m)-6(a) through (b)(2) is the same as the text of §§ 1.901(m)-6T(a) through (b)(2) published elsewhere in this issue of the **Bulletin**.]

(3) *Special considerations.* (i) If an asset is an RFA with respect to more than one foreign income tax, this paragraph (a) applies separately with respect to each foreign income tax.

(ii) Any subsequent cost recovery amount for an RFA transferred in a successor transaction is determined based on the post-transaction applicable cost recovery method, as described in § 1.901(m)-5(b)(3), that applies to the U.S. basis (or portion thereof) that corresponds to the unallocated basis difference.

(4)(i) [The text of proposed § 1.901(m)-6(b)(4)(i) is the same as the text of § 1.901(m)-6T(b)(4)(i) published elsewhere in this issue of the **Bulletin**.]

(ii) *Foreign basis election.* If a foreign basis election is made under § 1.901(m)-4(c) with respect to a foreign income tax in a subsequent CAA, any unallocated basis difference with respect to one or more prior CAAs will not be taken into account under section 901(m). The only basis difference that will be taken into account after the subsequent CAA with respect to that foreign income tax is the basis difference with respect to the subsequent CAA.

(b)(4)(iii) [The text of proposed § 1.901(m)-6(b)(4)(iii) is the same as the text of § 1.901(m)-6T(b)(4)(iii) published elsewhere in this issue of the **Bulletin**.]

(5) [The text of proposed § 1.901(m)-6(b)(5) is the same as the text of § 1.901(m)-6T(b)(5) published elsewhere in this issue of the **Bulletin**.]

(c) *Successor rules for aggregate basis difference carryover—(1) Transfers of a section 901(m) payor's aggregate basis difference carryover to another person.* If a corporation acquires the assets of a section

901(m) payor in a transaction to which section 381 applies, that corporation succeeds to any aggregate basis difference carryovers of the section 901(m) payor.

(2) *Transfers of a section 901(m) payor's aggregate basis difference carryover with respect to a foreign payor to another foreign payor.* If a section 901(m) payor has an aggregate basis difference carryover, with respect to a foreign income tax and a foreign payor, and substantially all of the assets of the foreign payor are transferred to another foreign payor in which the section 901(m) payor owns an interest, the section 901(m) payor's aggregate basis difference carryover with respect to the first foreign payor is transferred to the section 901(m) payor's aggregate basis difference carryover with respect to the other foreign payor. In such a case, the section 901(m) payor's aggregate basis difference carryover with respect to the first foreign payor is reduced to zero.

(3) *Anti-abuse rule.* If a section 901(m) payor has an aggregate basis difference carryover with respect to a foreign income tax and a foreign payor and, with a principal purpose of avoiding the application of section 901(m), assets of the foreign payor are transferred to another foreign payor in a transaction not described in paragraph (c)(1) or (2) of this section, then a portion of the aggregate basis difference carryover of the section 901(m) payor is transferred either to the aggregate basis difference carryover of the section 901(m) payor with respect to the other foreign payor or to another section 901(m) payor, as appropriate. The portion of the aggregate basis difference carryover transferred is determined based on the ratio of fair market value of the assets transferred to the fair market value of all of the assets of the foreign payor that transferred the assets. Similar principles apply when, with a principal purpose of avoiding the application of section 901(m), there is a change in the allocation of foreign income for foreign income tax purposes or the allocation of foreign income tax amounts for U.S. income tax purposes that would otherwise separate foreign income tax amounts from the related aggregate basis difference carryover.

(4) *Ownership.* For purposes of this paragraph (c), a section 901(m) payor owns an interest in a foreign payor if the section 901(m) payor owns the interest

directly or indirectly through one or more fiscally transparent entities for U.S. income tax purposes.

(d) *Effective/applicability date.* (1) [The text of proposed § 1.901(m)-6(d)(1) is the same as the text of § 1.901(m)-6T(d)(1) published elsewhere in this issue of the **Bulletin**.]

(2) Paragraphs (b)(3), (b)(4)(ii), and (c) of this section apply to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(3) Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section, § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)-1, §§ 1.901(m)-3 through 1.901(m)-5 (excluding § 1.901(m)-4(e)), § 1.901(m)-7, and § 1.901(m)-8 to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 9. Section 1.901(m)-7 is added to read as follows:

*§ 1.901(m)-7 De minimis rules.*

(a) *In general.* This section provides rules describing basis difference that is not taken into account under section 901(m) because a CAA results in a de minimis amount of basis difference. Paragraph (b) of this section sets forth the general rule for determining whether the de minimis threshold is met. Paragraph (c) of this section provides modifications to the general rule in the case of CAAs involving related persons and CAAs that are part of an aggregated CAA transaction. Paragraph (d) of this section provides rules for applying this section, and paragraph (e) of this section provides an anti-abuse rule applicable to related persons. Paragraph (f) of this section provides examples that illustrate the application of this section. Paragraph (g) of this section provides the effective/applicability date.

(b) *General rule*—(1) *In general.* A basis difference with respect to an RFA and a foreign income tax is not taken into account under section 901(m) if the re-

quirements under either the cumulative basis difference exemption or the RFA class exemption are satisfied.

(2) *Cumulative basis difference exemption.* Except as provided in paragraph (c) of this section, a basis difference, with respect to an RFA and a foreign income tax, is not taken into account under section 901(m) (cumulative basis difference exemption) if the sum of that basis difference and all other basis differences (including negative basis differences), with respect to a single CAA and a single RFA owner (U.S.), is less than the greater of:

(i) \$10 million, or

(ii) 10 percent of the total U.S. basis of all the RFAs immediately after the CAA.

(3) *RFA class exemption*—(i) Except as provided in paragraph (c) of this section, a basis difference, with respect to an RFA and a foreign income tax, is not taken into account under section 901(m) (RFA class exemption) if the RFA is part of a class of RFAs and the absolute value of the sum of the basis differences (including negative basis differences), with respect to a single CAA and a single RFA owner, for all the RFAs in that class is less than the greater of:

(A) \$2 million, or

(B) 10 percent of the total U.S. basis of all the RFAs in that class of RFAs immediately after the CAA.

(ii) For purposes of this paragraph (b)(3), the classes of RFAs are the seven asset classes defined in § 1.338-6(b), regardless of whether the CAA is a section 338 CAA.

(c) *Special rules*—(1) *Modification of de minimis rules for related persons.* If the transferor and transferee in the CAA are related persons (as described in section 267(b) or 707(b)), the cumulative basis difference exemption and the RFA class exemption, as described in paragraph (b) of this section, are applied by replacing the terms “\$10 million,” “10 percent”, and “\$2 million” wherever they occur in that paragraph with the terms “\$5 million,” “5 percent,” and “\$1 million,” respectively.

(2) *CAA part of an aggregated CAA transaction.* If a CAA is part of an aggregated CAA transaction and a single RFA owner (U.S.) does not own all the RFAs attributable to the CAAs that are part of the aggregated CAA transaction, the cumulative basis difference exemption and

the RFA class exemption apply to such CAA only if, in addition to satisfying the requirements of paragraph (b)(2) or (b)(3) of this section, respectively, determined without regard to this paragraph (c)(2), the cumulative basis difference exemption or the RFA class exemption, as modified by this paragraph (c)(2), is satisfied. Solely for purposes of this paragraph (c)(2), the cumulative basis difference exemption and the RFA class exemption are applied taking into account all the basis differences with respect to all the RFAs owned by all the RFA owners (U.S.) that are attributable to the CAAs that are part of the aggregated CAA transaction.

(d) *Rules of application.* The following rules apply for purposes of this section.

(1) Whether a basis difference qualifies for the cumulative basis difference exemption or the RFA class exemption is determined when an asset first becomes an RFA with respect to a CAA. In the case of a subsequent CAA described in § 1.901(m)–6(b)(4), the application of the cumula-

tive basis difference exemption and the RFA class exemption is based on basis difference, if any, that results from the subsequent CAA.

(2) If there is an aggregated CAA transaction, the cumulative basis difference exemption and each RFA class exemption are applied by treating all CAAs that are part of the aggregated CAA transaction as a single CAA.

(3) Basis difference is computed in accordance with § 1.901(m)–4 except that a foreign basis election need not be evidenced if either the cumulative basis difference exemption or an RFA class exemption apply to all RFAs with respect to the CAA.

(4) Basis difference is translated into U.S. dollars (if necessary) using the spot rate determined under the principles of § 1.988–1(d) on the date of the CAA.

(e) *Anti-abuse rule.* The cumulative basis difference exemption and an RFA class exemption are not available if the transferor and transferee in the CAA are related persons (as described in section

267(b) or 707(b)) and the CAA was entered into, or structured, with a principal purpose of avoiding the application of section 901(m). See also § 1.901(m)–8(c), which provides that certain built-in loss assets are not taken into account for purposes of applying this section.

(f) *Examples.* The following examples illustrate the rules of this section:

*Example 1. De minimis; cumulative basis difference exemption—(i) Facts.* USP, a domestic corporation, as part of a plan, purchases all of the stock of CFC1 and CFC2 from a single seller. CFC1 and CFC2 are section 902 corporations (as defined in section 909(d)(5)), organized in Country F, and treated as corporations for Country F tax purposes. Country F imposes a single tax that is a foreign income tax. Each acquisition is a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies. A foreign basis election is not made under § 1.901(m)–4(c). Immediately after the acquisition of the stock of CFC1 and CFC2, the assets of CFC1 and CFC2 give rise to income that is taken into account for Country F tax purposes, and those assets are in a single class, as defined in § 1.338–6(b). At all relevant times, 1u equals \$1. All amounts are stated in millions. The additional facts are summarized below.

Relevant Foreign Assets	Total U.S. Basis Immediately Before	Total U.S. Basis Immediately After	Total Basis Difference
Assets of CFC1	48u	60u	12u
Assets of CFC2	100u	96u	(4)u
Total	148u	156u	8u

(ii) *Result.* (A) Under § 1.901(m)–2(b)(1), USP's acquisitions of the stock of CFC1 and CFC2 are each a section 338 CAA. Under 1.901(m)–1(a)(3), the two section 338 CAAs constitute an aggregated CAA transaction because the acquisitions occur as part of a plan. Under § 1.901(m)–2(c)(1), the assets of CFC1 and CFC2 are RFAs for Country F tax purposes because they are relevant in determining foreign income of CFC1 and CFC 2, respectively, for Country F tax purposes. Under § 1.901(m)–1(a)(31), CFC1 is the RFA owner (U.S.) with respect to its assets, and CFC2 is the RFA owner (U.S.) with respect to its assets.

(B) Under paragraph (b)(2) of this section, the application of the cumulative basis difference exemption is based on a single CAA and a single RFA owner (U.S.), subject to the requirements under paragraph (c)(2) of this section that apply when there is an aggregated CAA transaction. In the case of the section 338 CAA with respect to CFC1, without regard to paragraph (c)(2) of this section, the requirements of the cumulative basis difference exemption are satisfied if the sum of the basis differences is less than the threshold of \$10 million, the greater of \$10 million or \$6 million (10% of the total U.S. basis of \$60 million (60 million u translated into dollars at the exchange rate of \$1 = 1u)). In this case, the sum of the basis differences is \$12 million (12 million u translated into dollars at the exchange rate of \$1 = 1 u).

Because the sum of the basis differences of \$12 million is not less than the threshold of \$10 million, the requirements of the cumulative basis difference exemption are not satisfied. Because the requirements of the cumulative basis difference exemption are not satisfied, without regard to paragraph (c)(2) of this section, paragraph (c)(2) of this section is not applicable. Finally, the RFA class exemption is not relevant because all of the RFAs of CFC1 are in a single class. Accordingly, the basis differences with respect to all of the RFAs of CFC1 must be taken into account under section 901(m).

(C) In the case of the section 338 CAA with respect to CFC2, without regard to paragraph (c)(2) of this section, the requirements of the cumulative basis difference exemption are satisfied if the sum of the basis differences is less than the threshold of \$10 million, the greater of \$10 million or \$ 9.6 million (10% of the total U.S. basis of \$96 million (96 million u translated into dollars at the exchange rate of \$1 = 1u)) In this case, the sum of the basis differences is (\$4) million ((4) million u translated into dollars at the exchange rate of \$1 = 1 u). Because the sum of the basis differences of (\$4) million is less than the threshold of \$10 million, the requirements of the cumulative basis difference exemption are satisfied. However, because the section 338 CAA with respect to CFC2 is part of an aggregate CAA transaction that includes the section 338 CAA

with respect to CFC1, paragraph (c)(2) of this section is applicable. Under paragraph (c)(2) of this section, the requirements of the cumulative basis difference exemption must also be satisfied taking into account all of the RFAs of both CFC2 and CFC1. In this case, the requirements of the cumulative basis difference exemption for purposes of paragraph (c)(2) of this section are satisfied if the sum of the basis differences with respect to all of the RFAs of CFC2 and CFC1 is less than the threshold of \$15.6 million, the greater of \$10 million or \$15.6 million (10% of the total U.S. basis of \$156 million (156 million u translated into dollars at the exchange rate of \$1 = 1u)) In this case, the sum of the basis differences is \$8 million (8 million u translated into dollars at the exchange rate of \$1 = 1 u). Because the sum of the basis differences of \$8 million is less than the threshold of \$15.6 million, the requirements of the cumulative basis difference exemption are satisfied in the case of the section 338 CAA with respect to CFC2. Accordingly, none of the basis differences with respect to the RFAs of CFC2 are taken into account under section 901(m).

*Example 2. De minimis; RFA Class Exemption—(i) Facts.* USP, a domestic corporation, acquires all the stock of CFC, a section 902 corporation (as defined in section 909(d)(5)) organized in Country F and treated as a corporation for Country F tax purposes, in a qualified stock purchase (as defined in section

338(d)(3)) to which section 338(a) applies. Country F imposes a single tax that is a foreign income tax. A foreign basis election is not made under § 1.901(m)–

4(c). Immediately after the acquisition of CFC, the assets of CFC give rise to income that is taken into account for Country F tax purposes. At all relevant

times, 1u equals \$1. All amounts are stated in millions. The additional facts are summarized below.

Relevant <i>Foreign Assets</i>	Total U.S. Basis Immediately Before	Total U.S. Basis Immediately After	Total Basis Difference
Cash (Class I)	10u	10u	0u
Inventory (Class IV)	14u	15u	1u
Buildings (Class V)	19u	30u	11u
Total	43u	55u	12u

(ii) *Result.* (A) Under § 1.901(m)–2(b)(1), USP’s acquisition of the stock of CFC is a section 338 CAA. Under § 1.901(m)–2(c)(1), the assets of CFC are RFAs for Country F tax purposes because they are relevant in determining foreign income of CFC for Country F tax purposes.

(B) Under paragraph (b)(2) of this section, the requirements of the cumulative basis difference exemption are satisfied if the sum of the basis differences is less than the threshold of \$10 million, the greater of \$10 million or \$5.5 million (10% of the total U.S. basis of \$55 million (55 million u translated into dollars at the exchange rate of \$1 = 1u)). In this case, the sum of the basis differences is \$12 million (12 million u translated into dollars at the exchange rate of \$1 = 1 u). Because the sum of the basis differences of \$12 million is not less than the threshold of \$10 million, the requirements of the cumulative basis difference exemption are not satisfied.

(C) Under paragraph (b)(3) of this section, each of CFC’s assets is allocated to its class under § 1.338–6(b) for purposes of the RFA class exemption. The requirements of the RFA class exemption with respect to the Class IV RFAs (in this case, inventory) are satisfied if the absolute value of the sum of the basis differences with respect to the Class IV RFAs is less than the threshold of \$2 million, the greater of \$2 million or \$1.5 million (10% of the total U.S. basis of Class IV RFAs of \$15 million (15 million u translated into dollars at the exchange rate of \$1 = 1u)) In this case, the absolute value of the sum of the basis differences is \$1 million (1 million u translated into dollars at the exchange rate of \$1 = 1 u). Because the sum of the basis differences of \$1 million is less than the threshold of \$2 million, the requirements of the RFA class exemption are satisfied. Accordingly, the basis differences with respect to the Class IV RFAs are not taken into account under section 901(m).

(D) The requirements of the RFA class exemption with respect to the Class V RFAs (in this case, buildings) is satisfied if the absolute value of the sum of the basis differences with respect to the Class V RFAs is less than the threshold of \$3 million, the greater of \$2 million or \$3 million (10% of the total U.S. basis of Class V RFAs of \$30 million (30 million u translated into dollars at the exchange rate of \$1 = 1u)). In this case, the absolute value of the sum of the basis differences is \$11 million (11 million u translated into dollars at the exchange rate of \$1 = 1 u). Because the sum of the basis differences of \$11 million is not less than the threshold of \$3 million, the requirements of the RFA class exemption are not satisfied. Accordingly, the basis differ-

ences with respect to the Class V RFAs are taken into account under section 901(m).

(E) The Class I RFAs (in this case, cash) are irrelevant because there is no basis differences with respect to those RFAs.

(g) *Effective/applicability date.* This section applies to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section, § 1.704–1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)–1, §§ 1.901(m)–3 through 1.901(m)–6 (excluding § 1.901(m)–4(e)), and § 1.901(m)–8 to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)–2 (excluding § 1.901(m)–2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

Par. 10. Section 1.901(m)–8 is added to read as follows:

*§ 1.901(m)–8 Miscellaneous.*

(a) *In general.* This section provides guidance on other matters under section 901(m). Paragraph (b) of this section provides guidance on the application of section 901(m) to pre-1987 foreign income taxes. Paragraph (c) of this section provides anti-abuse rules relating to built-in loss assets. Paragraph (d) of this section provides the effective/applicability date.

(b) *Application of section 901(m) to pre-1987 foreign income taxes.* Section 901(m) and §§ 1.901(m)–1 through –8 apply to pre-1987 foreign income taxes (as defined in § 1.902–1(a)(10)(iii)) of a section 902 corporation.

(c) *Anti-abuse rule for built-in loss RFAs.* A basis difference with respect to

an RFA described in section 901(m)(3)(C)(ii) (built-in loss RFA) will not be taken into account for purposes of computing an allocated basis difference for a U.S. taxable year of a section 901(m) payor if any RFA, including an RFA other than built-in loss RFAs, is acquired with a principal purpose of using one or more built-in loss RFAs to avoid the application of section 901(m). Furthermore, a basis difference with respect to a built-in loss RFA will not be taken into account for purposes of the cumulative basis difference exemption or the RFA class exemption under § 1.901(m)–7 if any RFAs, including RFAs other than built-in loss RFAs, are acquired with a principal purpose of avoiding the application of section 901(m).

(d) *Effective/applicability date.* This section applies to CAAs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers may, however, rely on this section prior to the date this section is applicable provided that they both consistently apply this section, § 1.704–1(b)(4)(viii)(c)(4)(v) through (vii), § 1.901(m)–1, and §§ 1.901(m)–3 through 1.901(m)–7 (excluding § 1.901(m)–4(e)) to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)–2 (excluding § 1.901(m)–2(d)) to all CAAs occurring on or after December 7, 2016. For this purpose, persons that are related (within the meaning of section 267(b) or 707(b)) will be treated as a single taxpayer.

John Dalrymple,  
Deputy Commissioner for  
Services and Enforcement.

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# 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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<sup>1</sup>A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2016–01 through 2016–26 is in Internal Revenue Bulletin 2016–26, dated June 27, 2016.

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