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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-110405-05

RIN 1545-BE58

Limitations on Transfers of Built-in Losses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 362(e)(2) of the Internal Revenue Code of 1986 (Code). The proposed regulations reflect changes made to the law by the American Jobs Creation Act of 2004. These proposed regulations provide guidance regarding the determination of the bases of assets and stock transferred in certain nonrecognition transactions and will affect corporations and large shareholders of corporations, including individuals, partnerships, corporations, and tax-exempt entities.

DATES: Written or electronic comments and requests for a public hearing must be received by January 22, 2007.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-110405-05), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand delivered to CC:PA:LPD:PR (REG-110405-05), Courier's Desk, Internal Revenue Service, Crystal Mall 4 Building, 1901 S. Bell

St., Arlington, VA. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or Federal e-Rulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-110405-05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jay M. Singer, (202) 622-7530, or concerning submissions of comments, Richard A. Hurst, (202) 622-7180 (not toll-free numbers) or [Richard.A.Hurst@irs.counsel.treas.gov](mailto:Richard.A.Hurst@irs.counsel.treas.gov).

SUPPLEMENTARY INFORMATION:

### **Background**

Prior to 1999, Congress grew concerned that taxpayers were engaging in corporate nonrecognition transactions in order to accelerate and duplicate losses. See S. Rep. No. 201, 106th Cong., 1st Sess. 46-48 (1999). Congress was primarily concerned with the acceleration and duplication of losses through the assumption of liabilities (including liabilities to which assets transferred in a corporate nonrecognition transaction were subject). As a result, in 1999, Congress enacted section 362(d) of the Code to prevent the bases of assets transferred to a corporation from being increased above such assets' aggregate fair market value as a result of a liability assumption. In addition, in 2000, Congress enacted section 358(h) to reduce the basis of stock received in certain corporate nonrecognition transactions, but not below fair market value, by the amount of any liabilities assumed in the transaction.

Following the enactment of sections 362(d) and 358(h), Congress remained concerned that taxpayers were engaging in various tax-motivated

transactions to take more than one tax deduction for a single economic loss. Consequently, in the American Jobs Creation Act of 2004 (Public Law 108-357, 188 Stat. 1418), Congress enacted section 362(e), which limits the ability of taxpayers to duplicate net built-in loss in certain nonrecognition transactions.

Section 362(e)(1)(A) provides that if there would be an importation of a net built-in loss in a transaction described in section 362(a) or (b), the basis of certain property acquired in such a transaction shall be its fair market value immediately after the transaction. Section 362(e)(1)(B) provides that property is described in section 362(e)(1) if gain or loss with respect to such property is not subject to tax in the hands of the transferor immediately before the transfer, and gain or loss with respect to such property is subject to tax in the hands of the transferee immediately after the transfer. Further, section 362(e)(1)(C) provides that there is an importation of net built-in loss in a transaction if the transferee's aggregate adjusted basis in such property would (but for the application of section 362(e)(1)) exceed the aggregate fair market value of such property immediately after the transaction.

Section 362(e)(2)(A) provides that if property is transferred by a transferor to a transferee in a transaction described in section 362(a) and not described in section 362(e)(1), and if the transferee's aggregate adjusted basis in the transferred property would (but for the application of section 362(e)(2)) exceed its aggregate fair market value immediately after the transfer, then the transferee's aggregate adjusted basis in the transferred property shall not exceed the fair market value of the property immediately after the transfer. Further, section

362(e)(2)(B) provides that this aggregate reduction in the basis of the transferred property shall be allocated among the property in proportion to their respective built-in losses immediately before the transaction. As an alternative to this reduction in the basis of the transferred assets, section 362(e)(2)(C) provides that if the transferor and the transferee both so elect, section 362(e)(2)(A) shall not apply, and the transferor's basis in the stock of the transferee received in exchange for the property that would otherwise be subject to basis reduction under section 362(e)(2)(A) shall not exceed its fair market value.

Since the enactment of section 362(e)(2), the IRS and Treasury Department have been exploring issues concerning the interpretation, scope, and application of the section and have proposed these regulations to address these issues. Additional guidance regarding the application of section 362(e)(2) to transfers between members of a consolidated group and the treatment of transactions that have the effect of importing losses into the U.S. tax system (to which section 362(e)(1) applies) will be addressed in separate guidance projects.

## **Explanation of Provisions**

### **1. General Provisions**

In general, these proposed regulations apply to transfers of net built-in loss property within the U.S. tax system in which the Code otherwise would duplicate the net built-in asset loss in the stock of the transferee. Such transfers include exchanges subject to section 351, capital contributions, and transfers of paid-in surplus. However, these proposed regulations do not apply to a transfer where the duplicated loss is imported into the U.S. tax system and the transfer is

subject to section 362(e)(1), which addresses certain loss importation transactions. Property is net built-in loss property if the transferee corporation's aggregate basis in the property, but for the application of section 362(e)(2), would exceed the aggregate fair market value of such property immediately after the transfer.

If section 362(e)(2) applies to a transfer, the transferee corporation receives the property with an aggregate basis not exceeding the aggregate fair market value of the property immediately after the transfer. The transferee allocates the basis reduction among the transferred loss properties in proportion to the amount of loss in each such property immediately before the transfer.

Taxpayers have questioned the effect of any gain taken into account as a result of the transfer. The IRS and Treasury Department have determined that any gain recognized by the transferor that increases the transferee corporation's basis in the transferred property must be taken into account in order to determine the full amount of loss duplication. Accordingly, these proposed regulations provide that in determining whether the transferred property has a net built-in loss in the hands of the transferee, the bases of such property first must be increased under section 362(a) or (b) for any gain recognized by the transferor on the transfer of the property.

There also have been questions about the application of section 362(e)(2) in the case of multiple transferors. The legislative history to section 362(e)(2) contains some potentially conflicting language that refers to the aggregate adjusted basis of property contributed by a transferor or a control group of which

the transferor is a member. See Conf. Rep. No. 108-755, 108th Cong., 2d Sess. 635 (2004). However, because the basis rules in section 362 and section 358 are applied on a transferor-by-transferor basis, applying section 362(e)(2) to an aggregated group of transferors would undermine Congress' intent to prevent loss duplication. Further, section 362(e)(2) specifically refers to property "transferred by a transferor." Accordingly, these proposed regulations clarify that section 362(e)(2) applies separately to each transferor. Thus, each transferor's transfer is measured separately, and the determination of whether that transfer is subject to these provisions is made solely by reference to the property transferred by such transferor. Consequently, the treatment of one transferor is unaffected by the transfer of property by any other transferor for purposes of section 362(e)(2).

In addition, these proposed regulations clarify that, even if part of a transaction is subject to section 362(e)(1), section 362(e)(2) can apply to the portion of the transaction that is not described in section 362(e)(1).

## 2. Application of Section 362(e)(2) to Transfers Outside of the U.S. Tax System

Under general principles of law, the Code applies to all transactions without regard to whether such application has any current U.S. tax consequences. In the case of transfers that are wholly outside the U.S. tax system, section 362(e)(2) applies but does not have relevance unless and until the assets transferred or the stock received in the exchange enter the U.S. tax system. Such assets or stock may subsequently enter the U.S. tax system either directly or indirectly. For example, the assets or stock could directly enter the

U.S. tax system through a transfer of all or a portion of such assets or stock to a U.S. person, or as a result of the original transferor or original transferee becoming a U.S. person. Further, the assets or stock could indirectly enter the U.S. tax system, for example, through a transfer of all or a portion of such assets or stock to a CFC, or as a result of the original transferor or original transferee becoming a CFC. However, in many cases the U.S. tax treatment of a transfer that is wholly outside the U.S. tax system will never become relevant. The IRS and Treasury Department recognize that, if a transferor does not anticipate the transfer becoming U.S. tax relevant, it is not likely to undertake the valuation and record-keeping that section 362(e)(2) would generally require. If circumstances change at some later date, the administrative burden of reconstructing appropriate records may be substantial.

The IRS and Treasury Department have determined that relief is appropriate when transactions are consummated with no plan or intention to enter the U.S. tax system. Thus, if assets are transferred in a transaction that is potentially subject to section 362(e)(2) more than two years before entering the U.S. tax system, then, solely for purposes of section 362(e)(2), these proposed regulations generally presume that the aggregate fair market value of the transferred assets equals their aggregate adjusted basis in the hands of the transferee immediately after the transfer. This presumption applies only if neither the original transfer nor the later entry of any portion of the assets into the U.S. tax system was undertaken with a view to reducing the U.S. tax liability of any person or duplicating loss by avoiding the application of section 362(e)(2).

If a transfer subject to section 362(e)(2) occurs within the two-year period immediately before becoming U.S. tax relevant, the IRS and Treasury Department do not believe that relief from the administrative burden is either necessary or appropriate. Thus, in such a case, the fair market value presumption does not apply, and section 362(e)(2) applies to the original transfer. The proposed regulations provide the relevant parties a means by which to make an election under section 362(e)(2)(C), if desired, at the time of entry into the U.S. tax system.

### 3. General Application of Section 362(e)(2) to Reorganizations

Taxpayers have questioned whether a transaction described in both sections 362(a) and 362(b) may be subject to section 362(e)(2). The IRS and Treasury Department believe that, if there is a duplication of loss in a transaction described in section 362(a) (and not subject to section 362(e)(1)), Congressional intent requires that the transaction be recognized as described in section 362(a) notwithstanding that it is also described in section 362(b). The proposed regulations clarify that section 362(e)(2) can apply to such transactions.

### 4. Exception for Transactions in Which Net Built-in Loss is Eliminated Without Recognition

In certain transactions, the transferor's duplicated basis in the transferee stock or securities is eliminated by operation of statute without recognition or benefit. For example, in a transaction meeting the requirements of both sections 351 and 368(a)(1)(D), the transferor ordinarily receives stock with an aggregate basis equal to that of the transferred property. As a result, where the transferred

property has a net built-in loss, but for section 362(e)(2), the transferor would receive the transferee stock with an adjusted basis that duplicates the built-in loss in the transferred property. However, if the transferor distributes the transferee stock pursuant to a section 368(a)(1)(D) acquisitive reorganization or pursuant to section 355, no taxpayer will recognize the duplicated loss because the distributee will determine its basis in the transferee stock by reference to its basis in surrendered stock of the transferor.

The IRS and Treasury Department have concluded that, even if a transaction is described in section 362(e)(2), if there is no duplicated loss that can be recognized, section 362(e)(2) should not apply. Accordingly, these proposed regulations provide that section 362(e)(2) will not apply to transactions to the extent that loss duplication is prevented or eliminated where the transferor distributes the transferee stock and/or securities received in the transaction without recognizing gain or loss, and, upon completion of the transaction, no person holds any asset with a basis determined in whole or in part by reference to the transferor's basis in the transferee stock and/or securities.

##### 5. Application of Section 362(e)(2) to Transfers in Exchange for Securities

In certain transactions, net built-in loss also can be duplicated in securities received without the recognition of gain or loss. For example, a U.S. transferor duplicates a net built-in loss when it transfers property with a net built-in loss to a U.S. controlled corporation in exchange for stock and securities and all or part of the securities are retained following the distribution of the stock of the controlled corporation pursuant to section 355. Such a transaction is described in section

362(a) but not section 362(e)(1) and, accordingly, may be subject to section 362(e)(2).

Although the statute is silent about the treatment of securities received in such a property transfer, the IRS and Treasury Department have concluded that Congressional intent would be circumvented if section 362(e)(2) were treated as not applying to both stock and securities received in transactions to which section 362(e)(2) applies. Accordingly, these proposed regulations apply section 362(e)(2) to transfers in exchange for both stock and securities to the extent necessary to eliminate loss duplication.

Because the section applies equally to transfers in exchange for both stock and securities, the IRS and Treasury Department have concluded that taxpayers must be allowed to make an election under section 362(e)(2)(C) for both stock and securities. Accordingly, these proposed regulations allow the transferor and transferee to elect to apply section 362(e)(2)(C) to the transferee stock and securities received in the exchange.

#### 6. Election to Reduce Stock Basis

Section 362(e)(2)(C) permits transferors and transferees that engage in transactions to which section 362(e)(2) applies to elect to reduce the transferor's basis in the stock received instead of reducing the transferee corporation's basis in the property transferred. As described in this preamble, section 362(e)(2)(C) provides that if the election is made, section 362(e)(2)(A) shall not apply, and the transferor's basis in the transferee stock received in the exchange shall not exceed its fair market value immediately after the exchange. The statutory

language might be interpreted to require the transferor to reduce its basis in the stock received by an amount that is larger than the amount by which the transferee otherwise would have been required to reduce its aggregate basis in the assets under section 362(e)(2)(A). For example, assume a corporation, P, contributes a trade or business to a subsidiary, S, in a transaction to which section 351 applies. The assets of the business have an aggregate adjusted basis of \$100 and a value of \$90, and the business has \$20 of associated contingent liabilities. Even if section 358(h)(2)(A) applies to prevent section 358 from reducing P's basis in the S stock by the amount of the contingent liabilities, section 362(e)(2)(C) might be interpreted to limit P's basis in the S stock to \$70 (notwithstanding that section 362(e)(2)(A) would only require a \$10 reduction in the basis of the assets in the hands of S). Thus, a section 362(e)(2)(C) election might result in a larger basis reduction in the stock than would be required in the assets absent an election.

The IRS and Treasury Department believe that, because section 362(e)(2) is intended to prevent the duplication of net built-in loss in the transferred assets, the amount of basis reduction resulting from an election under section 362(e)(2)(C) should not be any larger than what is necessary to eliminate the duplication of loss in the transferred assets. Therefore, these proposed regulations clarify that the amount of the reduction in the basis of the transferee stock (and securities) as a result of an election to apply section 362(e)(2)(C) is equal to the net built-in loss in the transferred assets in the hands of the transferee. In other words, under the proposed regulations, the amount of the

reduction in the basis of the transferee stock (and securities) resulting from such an election equals the amount of the reduction in the basis of the assets required by section 362(e)(2)(A) absent the election.

These proposed regulations also implement Notice 2005-70, 2005-41 IRB 694, see §601.601(d)(2), which instructs taxpayers how to elect to apply section 362(e)(2)(C). These proposed regulations revise and expand upon the procedures in Notice 2005-70 to provide more methods and time periods in which to make the section 362(e)(2)(C) election. Specifically, the regulations expand the classifications of persons who can attach the required election statement to a tax return (including an information return).

The "protective election" referenced in Notice 2005-70 also is included in the proposed regulations because the IRS and Treasury Department anticipate that, at the time of the transaction, taxpayers may not always be able to determine with reasonable certainty whether section 362(e)(2) applies to a transfer.

The IRS and Treasury Department request comments on whether the instructions provided in these proposed regulations adequately address the needs of taxpayers. In particular, the IRS and Treasury Department invite comments regarding whether, alternatively, a separate form should be developed and made available to enable taxpayers to make the section 362(e)(2)(C) election prior to and apart from filing it with a U.S. return.

The basis tracing provisions in §1.358-2 apply to certain transfers to which section 351 and either section 354 or section 356 apply. However, the IRS and

Treasury Department believe that the basis tracing provisions in §1.358-2 should not apply to a transfer to which section 362(e)(2) also applies if the transferor and transferee make an election to apply section 362(e)(2)(C). The IRS and Treasury Department believe that the statutory language in section 362(e)(2)(C) and the policy of preventing loss duplication precludes the application of the basis tracing provisions because basis tracing could allow the transferor to hold transferee stock or securities with a basis in excess of fair market value even after a reduction under section 362(e)(2)(C). Accordingly, these proposed regulations provide that the provisions of §1.358-2(a)(2) will not apply to a transaction to which section 362(e)(2) applies if the transferor and transferee elect to apply section 362(e)(2)(C). The IRS and Treasury Department request comments regarding whether this treatment is appropriate.

#### 7. Transfers by Partnerships and S Corporations

The proposed regulations also provide that, where the transferor is a partnership and a section 362(e)(2)(C) election is made, any reduction to the partnership's basis in the transferee stock received is treated as an expenditure of the partnership, as described in section 705(a)(2)(B). The proposed regulations provide a similar rule applicable to transfers by S corporations that elect to apply section 362(e)(2)(C).

The IRS and Treasury Department are further exploring how the provisions of section 362(e)(2) apply to partnerships. The IRS and Treasury Department invite comments on this general issue and specifically invite comments regarding the transfer of a partnership interest in exchange for stock

in a section 351 transaction to which section 362(e)(2) applies. For example, individuals A and B contribute cash to form a partnership, PRS. PRS purchases property that subsequently decreases in value. A contributes his PRS interest to a corporation in a transaction that qualifies under section 351. PRS does not make an election under section 754. Comments are invited regarding the interaction of section 362(e)(2) and the partnership provisions under these and similar facts.

#### 8. Application of Section 336(d) to Property Previously Transferred in a Section 362(e)(2) Transaction

Commentators have questioned how section 362(e)(2) interacts with other Code sections. Specifically, some have asked how section 362(e)(2) applies when section 336(d) might be implicated. Section 336(d) provides various limitations on a liquidating corporation's ability to recognize loss when it distributes property acquired in a section 351 transaction or as a contribution to capital. The IRS and Treasury Department believe that, generally, sections 336(d) and 362(e)(2) are fully compatible where the parties do not make an election to apply section 362(e)(2)(C). However, where an election has been made, the two sections may operate to deny part or all of an economic loss. The IRS and Treasury Department invite comments regarding this issue.

#### 9. Application to Section 304 Transactions

In response to inquiries, the proposed regulations contain an example demonstrating how section 362(e)(2) applies to a section 351 transaction treated as occurring under section 304. The IRS and Treasury Department are

considering whether the regulations should deem an election to apply section 362(e)(2)(C) to have been made in section 304 transactions. The IRS and Treasury Department invite comments regarding this issue.

### **Proposed Effective Date**

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

### **Special Analyses**

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

### **Comments and Requests for a Public Hearing**

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

public inspection and copying. A public hearing may be scheduled if requested in writing by any 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 Jay M. Singer and Filiz A. Serbes of the Office of Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **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 an entry in numerical order to read in part as follows:

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

Section 1.362-4 also issued under 26 U.S.C. 362. \* \* \*

Par. 2. Section 1.358-2 is amended by revising paragraphs (a)(2)(viii) and adding a new sentence at the end of paragraph (d) to read as follows:

§1.358-2 Allocation of basis among nonrecognition property.

(a) \* \* \*

(2) \* \* \*

(viii) This paragraph (a)(2) shall not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and either section 354 or section 356, if, in connection with the exchange, the shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor section 356 applies, the shareholder or security holder exchanges property for stock or securities to which it elects to apply section 362(e)(2)(C), or liabilities of the shareholder or security holder are assumed.

\* \* \* \* \*

(d) \* \* \* Paragraph (a)(2)(viii) of this section applies to exchanges and distributions of stock occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 3. In §1.362-3, the section heading is added and reserved to read as follows:

§1.362-3 Limitations on loss importation. [Reserved].

Par. 4. Section 1.362-4 is added to read as follows:

§1.362-4 Limitations on built-in loss duplication.

(a) Purpose and scope. The purpose of this section is to prevent the duplication of net built-in loss in transactions described in section 362(e)(2). Section 362(e)(2) applies to transfers of net built-in loss property described in section 362(a) but only to the extent not described in section 362(e)(1).

(b) Application—(1) In general. If property is transferred in any transaction described in section 362(a) but not section 362(e)(1), and, in the

hands of the transferee, the transferred property would otherwise have a net built-in loss immediately after the transfer, then the transferee corporation receives such property with an aggregate adjusted basis not exceeding the aggregate fair market value of such property immediately after the transfer. If multiple built-in loss properties are transferred, the aggregate reduction in basis shall be allocated among the built-in loss properties so transferred in proportion to the relative amount of built-in loss in each property.

(2) Multiple transferors. If more than one transferor transfers property to a corporation in a transaction described in section 362(a), whether and the extent to which this section applies is determined separately for each transferor.

(3) Transactions described in section 362(e)(1). A transfer of property to a corporation is described in section 362(e)(1) only if and to the extent that the transferred property described in section 362(e)(1)(B) (section 362(e)(1)(B) property) would otherwise have a net built-in loss in the hands of the transferee. Thus, if a transferor transfers net built-in loss section 362(e)(1)(B) property together with property not described in section 362(e)(1)(B), the transfer of the net built-in loss section 362(e)(1)(B) property is described in section 362(e)(1). Accordingly, the net built-in loss section 362(e)(1)(B) property is not taken into account for purposes of determining whether section 362(e)(2) applies to the transfer of the other property. Alternatively, if a transferor transfers net built-in gain section 362(e)(1)(B) property together with property not described in section 362(e)(1)(B), no portion of the transfer is described in section 362(e)(1).

(4) Net built-in loss-- (i) In general. Transferred property has a net built-in loss if its aggregate adjusted basis exceeds its aggregate fair market value.

(ii) Basis adjustments for gain recognized on the transfer. For purposes of determining whether the transferred property has a net built-in loss in the hands of the transferee, the bases of such property first must be increased under section 362(a) or (b) for any gain recognized by the transferor on the transfer of such property.

(5) Application of section 362(e)(2) to reorganizations. Section 362(e)(2) can apply to a transfer regardless of whether the basis of the property would, but for section 362(e)(2), be determined under section 362(b).

(6) Exception for transactions in which net built-in loss is eliminated without recognition. Section 362(e)(2) does not apply to a transfer of property to the extent that--

(i) The transferor distributes, without recognizing gain or loss, all of the transferee stock received in exchange for the transferred property; and

(ii) Upon completion of the transaction, no person holds transferee stock or any other asset with a basis determined in whole or in part by reference to the transferor's basis in the transferee stock.

(7) Transfers where neither party is a U.S. person, a person otherwise required to file a U.S. return, or a CFC. If property is transferred in a transaction described in section 362(a) but not section 362(e)(1), then, solely for purposes of section 362(e)(2), the aggregate fair market value of the transferred property

shall be deemed to equal the aggregate adjusted basis of such property in the hands of the transferee immediately after the transfer if—

(i) Neither party to the transfer was a United States (U.S.) person (as defined in section 7701(a)(30)) on the date of the transfer;

(ii) Neither party to the transfer was required to file a return of tax under Subtitle A of the Internal Revenue Code (including an information return) for the year of the transfer;

(iii) Neither party to the transfer was a controlled foreign corporation (CFC), as defined in section 957, on the date of the transfer;

(iv) The transfer occurred more than two years prior to the date on which the transferor, transferee, or transferred assets are first described in paragraph (c)(5)(iii) of this section; and

(v) Neither the transfer nor the later entry into the U.S. tax system was entered into with a view to reducing the U.S. Federal income tax liability of any person or duplicating loss by avoiding the application of section 362(e)(2).

(c) Section 362(e)(2)(C) election to apply limitation to transferor's stock basis—(1) In general. If section 362(e)(2) applies to a transfer, the transferor and the transferee may make a joint election to reduce the transferor's basis in the transferee stock instead of reducing the transferee's basis in the property received under paragraph (b) of this section. Once made, the election is irrevocable. If the election is made, the transferor's basis in the transferee stock is reduced upon receipt by the transferor. The transferor and the transferee may make a protective election under this section, which will have no effect if section

362(e)(2) does not apply to the transfer, but which will otherwise be binding and irrevocable.

(2) Stock and securities to which this section applies. For purposes of this section, the term stock means stock and securities received without the recognition of gain or loss in a transaction to which section 362(e)(2) applies. See, for example, transactions described in sections 368(a)(1)(D) and 355.

(3) Amount of basis reduction. If an election is made pursuant to paragraph (c)(1) of this section, the amount of the basis reduction in the transferee stock received by the transferor in the transaction is equal to the total amount by which the aggregate basis of the transferred property would have been reduced under paragraph (b) of this section had such election not been made.

(4) Allocation of basis reduction. The transferor shall allocate the amount of the basis reduction under this paragraph (c) among all transferee stock received in the transaction in proportion to fair market value.

(5) Procedures for making the election—(i) In general. To make an election to apply section 362(e)(2)(C)--

(A) Prior to filing the election statement as described in paragraph (c)(5)(ii) or (c)(5)(iii) of this section, the transferor and transferee must execute a written, binding agreement electing to apply section 362(e)(2)(C); and

(B) An election statement must be filed pursuant to paragraph (c)(5)(ii) or (c)(5)(iii) of this section.

(ii) Election statement where the transferor or transferee is a U.S. person, a person otherwise required to file a U.S. return for the year of the transfer, or a CFC on the date of the transfer--(A) Transferor is a U.S. person or a person otherwise required to file a U.S. return for the year of the transfer. If the transferor is a U.S. person on the date of the transfer or a person otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) for the year of the transfer, the election statement is filed by including the following statement on or with the transferor's timely filed original return (including extensions) for the taxable year in which the transfer occurred: "[insert name and tax identification number of transferor] certifies that [insert name and tax identification number of transferor] and [insert name and tax identification number, if any, of transferee] elect to apply section 362(e)(2)(C) with respect to a transfer of property described in section 362(e)(2)(A) on [insert date(s) of transfer(s)]."

(B) Transferor is a CFC on the date of the transfer. If, on the date of the transfer, the transferor is a CFC that is not required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) for the year of the transfer, the election statement is filed by including the following statement on or with the timely filed original return (including extensions) of each one of the transferor's controlling U.S. shareholders, as defined in §1.964-1(c)(5), for the taxable year within which the transfer occurred: "[insert name and tax identification number of controlling U.S. shareholder filing return] certifies that [insert name and tax identification number, if any, of transferor (the CFC)] and

[insert name and tax identification number, if any, of transferee] elect to apply section 362(e)(2)(C) with respect to a transfer of property described in section 362(e)(2)(A) on [insert date(s) of transfer(s)]. [insert name(s) and tax identification number(s) of any other controlling U.S. shareholder(s) of the CFC, or, if none, state that there are no other controlling U.S. shareholders of the CFC]."

(C) Transferor is not a U.S. person on the date of the transfer, a person otherwise required to file a U.S. return for the year of the transfer, or a CFC on the date of the transfer, and transferee is a U.S. person on the date of the transfer or a person otherwise required to file a U.S. return for the year of the transfer. If the transferor is not described in paragraph (c)(5)(ii)(A) or (c)(5)(ii)(B) of this section and the transferee is a U.S. person on the date of the transfer or otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) for the year of the transfer, the election statement is filed by including the following statement on or with the transferee's timely filed original return (including extensions) for the taxable year in which the transfer occurred: "[insert name and tax identification number of transferee] certifies that [insert name and tax identification number, if any, of transferor] and [insert name and tax identification number of transferee] elect to apply section 362(e)(2)(C) with respect to a transfer of property described in section 362(e)(2)(A) on [insert date(s) of transfer(s)]."

(D) Transferor is not a U.S. person on the date of the transfer, a person otherwise required to file a U.S. return for the year of the transfer, or a CFC on

the date of the transfer, and transferee is a CFC on the date of the transfer. If the transferor is not described in paragraph (c)(5)(ii)(A) or (c)(5)(ii)(B) of this section, and, on the date of the transfer, the transferee is a CFC that is not required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) for the year of the transfer, the election statement is filed by including the following statement on or with the timely filed original return (including extensions) of each one of the transferee's controlling U.S. shareholders as defined in §1.964-1(c)(5) for the taxable year within which the transfer occurred: "[insert name and tax identification number of controlling U.S. shareholder filing return] certifies that [insert name and tax identification number, if any, of transferor] and [insert name and tax identification number, if any, of transferee (the CFC)] elect to apply section 362(e)(2)(C) with respect to a transfer of property described in section 362(e)(2)(A) on [insert date(s) of transfer(s)]. [insert name(s) and tax identification number(s) of any other controlling U.S. shareholder(s) of the CFC, or, if none, state that there are no other controlling U.S. shareholders of the CFC]."

(iii) Election where neither the transferor nor the transferee is a U.S. person on the date of the transfer, a person otherwise required to file a U.S. return for the year of the transfer, or a CFC on the date of the transfer. If the parties to a transfer to which section 362(e)(2) applies are not described in any of the classifications set forth in paragraph (c)(5)(ii) of this section, then the election statement under this paragraph (c) is made as described in this paragraph (c)(5)(iii).

(A) Transferor later becomes a U.S. person, a person otherwise required to file a U.S. return, or a CFC. If the transferor later becomes a U.S. person, a person otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return), or a CFC, an election statement under this paragraph (c) is filed as described in this paragraph (c)(5)(iii)(A).

(1) If the transferor becomes a U.S. person or a person otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return), the election statement is filed by including the statement described in paragraph (c)(5)(ii)(A) of this section on or with the transferor's timely filed original return (including extensions) for the taxable year in which the transferor first becomes a U.S. person or a person otherwise required to make a return.

(2) If the transferor becomes a CFC that is not required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return), the election statement is filed by including the statement described in paragraph (c)(5)(ii)(B) of this section on or with the timely filed original return (including extensions) of each one of the transferor's controlling U.S. shareholders, as defined in §1.964-1(c)(5), for the taxable year within which the transferor becomes a CFC.

(B) Transferee later becomes a U.S. person, a person otherwise required to file a U.S. return, or a CFC. If the transferor is not described in paragraph (c)(5)(iii)(A) of this section, and the transferee later becomes a U.S. person, a person otherwise required to make a return of tax under Subtitle A of the Internal

Revenue Code (including an information return), or a CFC, an election statement under this paragraph (c) is filed as described in this paragraph (c)(5)(iii)(B).

(1) If the transferee becomes a U.S. person or a person otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return), the election statement is filed by including the statement described in paragraph (c)(5)(ii)(C) of this section on or with the transferee's timely filed original return (including extensions) for the taxable year in which the transferee first becomes required to make a return.

(2) If the transferee becomes a CFC that is not required to make any return of tax under Subtitle A of the Internal Revenue Code (including an information return), the election statement is filed by including the statement described in paragraph (c)(5)(ii)(D) of this section on or with the timely filed original return (including extensions) of each one of the transferee's controlling U.S. shareholders as defined in §1.964-1(c)(5) for the taxable year within which the transferee becomes a CFC.

(C) A U.S. person, a person otherwise required to file a U.S. return, or a CFC later acquires the transferred assets or transferee stock in a transferred basis transaction. If neither the transferor nor the transferee is described in paragraph (c)(5)(iii)(A) or (c)(5)(iii)(B) of this section and a U.S. person, a person otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return), or a CFC not required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) later acquires, in a transferred basis transaction, any portion

of the assets that were transferred in a prior transaction to which section 362(e)(2) applied (section 362(e)(2) assets) or stock of the transferee corporation received in such prior transaction (section 362(e)(2) stock), then the election statement under this paragraph (c) is filed as described in this paragraph (c)(5)(iii)(C).

(1) If a U.S. person or a person otherwise required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) later acquires, in a transferred basis transaction, any portion of the section 362(e)(2) assets or section 362(e)(2) stock, the election statement is filed by including the following statement on or with such acquiror's timely filed original return (including extensions) for the taxable year in which the acquiror first acquires any portion of the section 362(e)(2) assets or section 362(e)(2) stock: "[insert name and tax identification number of the acquiror] certifies that [insert name and tax identification number, if any, of transferor] and [insert name and tax identification number, if any, of transferee] elect to apply section 362(e)(2)(C) with respect to a transfer of property described in section 362(e)(2)(A) on [insert date(s) of transfer(s)]."

(2) If no person described in paragraph (c)(5)(iii)(C)(1) of this section has acquired any portion of the section 362(e)(2) assets or section 362(e)(2) stock, and a CFC not required to make a return of tax under Subtitle A of the Internal Revenue Code (including an information return) later acquires, in a transferred basis transaction, any portion of the section 362(e)(2) assets or section 362(e)(2) stock, the election statement is filed by including the following statement on or

with each of the CFC's controlling U.S. shareholders' timely filed original returns (including extensions) for the taxable year within which the CFC first acquires any portion of the section 362(e)(2) assets or section 362(e)(2) stock: "[insert name and tax identification number of controlling U.S. shareholder filing return] certifies that [insert name and tax identification number, if any, of transferor] and [insert name and tax identification number, if any, of transferee] elect to apply section 362(e)(2)(C) with respect to a transfer of property described in section 362(e)(2)(A) on [insert date(s) of transfer(s)]. [insert name(s) and tax identification number(s) of any other controlling U.S. shareholder(s) of the CFC, or, if none, state that there are no other controlling U.S. shareholders of the CFC]."

(6) Transfers by partnerships. If the transferor is a partnership, for purposes of applying section 705 (determination of basis of partner's interest), any reduction under this section to the transferor's basis in the stock received in exchange for the transferred property is treated as an expenditure of the partnership described in section 705(a)(2)(B).

(7) Transfers by S corporations. If the transferor is an S corporation, for purposes of applying section 1367 (adjustments to basis of stock of shareholders, etc.), any reduction under this section to the transferor's basis in the stock received in exchange for the transferred property is treated as an expense of the S corporation described in section 1367(a)(2)(D).

(d) Examples. The following examples illustrate paragraphs (a) through (c) of this section. Unless otherwise indicated, all transferred property is subject

to tax under Subtitle A of the Internal Revenue Code in the hands of the transferor, and, accordingly, section 362(e)(1) does not apply to the transaction.

In addition, all assets are capital assets in the hands of the transferor and have been held for more than one year.

Example 1. Property transfer qualifying under section 351. (i) Facts. Individual A owns Asset 1 with a basis of \$90 and a fair market value of \$60, and Asset 2 with a basis of basis of \$110 and a fair market value of \$120. In a transaction qualifying under section 351, A transfers Asset 1 and Asset 2 to newly formed corporation X in exchange for all of the X common stock. A and X do not elect to apply section 362(e)(2)(C) to reduce A's basis in the X stock received.

(ii) Analysis. Under section 362(a), X would otherwise receive Asset 1 and Asset 2 with an aggregate basis of \$200 (\$90+\$110), which exceeds their aggregate fair market value of \$180 (\$60+\$120). As a result, the assets have a net built-in loss of \$20, and this section applies to the transfer. Under paragraph (b)(1) of this section, X reduces its basis in Asset 1 by \$20 to \$70 and, under section 362(a), takes a basis in Asset 2 of \$110. Under section 358(a), A receives X stock with a basis of \$200.

(iii) Election to apply section 362(e)(2)(C). The facts are the same as in paragraph (i) of this Example 1, except that A and X elect to apply section 362(e)(2)(C) to reduce A's basis in the X stock received. Under paragraph (c)(3) of this section, A reduces its basis in the X stock received by the amount X would have been required to reduce its basis in the transferred assets had the election to apply section 362(e)(2)(C) not been made. Accordingly, A receives X stock with an aggregate basis of \$180, and, under section 362(a), X receives Asset 1 with a basis of \$90 and Asset 2 with a basis of \$110.

Example 2. Property transfer qualifying under section 351 and described in section 368(a)(1)(B). (i) Facts. Corporation P owns all of the outstanding stock of corporations S1 and S2. In a transaction qualifying under section 351 and described in section 368(a)(1)(B), P transfers all 10 shares of its S2 stock to S1 in exchange for an additional 10 shares of S1 voting stock. At the time of the transfer, each share of the S2 stock has a basis of \$10 and a fair market value of \$7. P and S1 do not elect to apply section 362(e)(2)(C) to reduce P's basis in its S1 stock.

(ii) Analysis. Under section 362, S1 would otherwise receive the 10 shares of S2 stock with a basis of \$10 per share, which exceeds their fair market value of \$7 per share. As a result, the S2 stock has a net built-in loss of \$30, and this section applies to the transfer. Under paragraph (b)(1) of this section, S1

reduces its basis in the S2 stock by \$30 to \$70. Under section 358(a), P receives the additional 10 shares of S1 stock with a basis of \$10 per share.

(iii) Election under section 362(e)(2)(C). (A) The facts are the same as in paragraph (i) of this Example 2, except that P and S1 elect to apply section 362(e)(2)(C) to reduce P's basis in its S1 stock received. Under paragraph (c)(3) of this section, P reduces its basis in the S1 stock received by the amount S1 would have been required to reduce its basis in the transferred S2 stock had the election to apply section 362(e)(2)(C) not been made. Accordingly, under paragraph (c)(4) of this section, P receives the additional 10 shares of S1 stock each with a basis of \$7. Under section 362, S1 receives the 10 shares of S2 stock each with a basis of \$10.

(B) The facts are the same as in paragraph (i) of this Example 2, except that five shares of the S2 stock have a basis of \$10 each, five shares have a basis of \$5 each, and P and S1 elect to apply section 362(e)(2)(C) to reduce P's basis in its S1 stock. The \$75 ((5 X \$10) + (5 x \$5)) aggregate basis in the S2 stock exceeds the \$70 aggregate fair market value of the S2 stock, and this section applies to the transfer. Under paragraph (c)(3) of this section, P reduces its basis in the S1 stock received by the amount S1 would have been required to reduce its basis in the transferred S2 stock had the election to apply section 362(e)(2)(C) not been made. Accordingly, under paragraph (c)(4) of this section and §1.358-2(a)(2)(viii), P receives the additional 10 shares of S1 stock each with a basis of \$7. Under section 362, S1 receives five shares of the S2 stock with a basis of \$10 each and five shares of the S2 stock with a basis of \$5 each.

Example 3. Property transfer qualifying under section 351 and described in section 368(a)(1)(A). (i) Facts. Individual A owns all of the outstanding stock of corporation X and corporation Y, which owns Asset 1 with an adjusted basis of \$250 and a fair market value of \$210. A also owns Asset 2 with an adjusted basis of \$120 and a fair market value of \$130. In a transaction qualifying as a reorganization described in section 368(a)(1)(A), Y merges with and into X. Pursuant to the same plan, A transfers Asset 2 to X in exchange for additional X stock. Y's transfer of Asset 1 to X in the merger coupled with A's transfer of Asset 2 to X in exchange for X stock qualifies as a section 351 contribution.

(ii) Analysis. Under paragraph (b)(2) of this section, the potential application of section 362(e)(2) is determined separately for each transferor. Y is treated as having transferred Asset 1 to X in exchange for X stock, and X would otherwise take Asset 1 with a basis of \$250, which exceeds its fair market value of \$210. As a result, Asset 1 has a built-in loss of \$40. Under paragraph (b)(6) of this section, section 362(e)(2) does not apply to Y's transfer of property to X because Y distributes all of the X stock received in the exchange without recognizing gain or loss pursuant to section 361(c), and, upon completion of the transaction, no person holds X stock or any other asset with a basis determined in whole or in part by reference to Y's basis in the X stock received in the

exchange. As a result, under section 362, X receives Asset 1 with a basis of \$250. A's transfer of Asset 2 to X is not subject to section 362(e)(2) because X receives Asset 2 with a basis of \$120, which is less than its fair market value of \$130.

Example 4. Property transfers qualifying under section 351 and described in section 368(a)(1)(D), followed by a section 355 distribution. (i) Facts.

Individual A and individual B each own 50 percent of corporation X. X owns Asset 1 with an adjusted basis of \$120 and a fair market value of \$70, Asset 2 with an adjusted basis of \$160 and a fair market value of \$110, and Asset 3 with an adjusted basis of \$220 and a fair market value of \$240. In a transaction qualifying under section 351(a) and described in section 368(a)(1)(D), X transfers Asset 1, Asset 2, and Asset 3 to Y, a newly formed corporation, in exchange for all of the Y stock, and then distributes all of the Y stock to A in exchange for all of A's X stock in a distribution qualifying under section 355. At the time of the transaction, A has no plan or intention to dispose of his Y stock, and B has no plan or intention to dispose of his X stock.

(ii) Analysis. The aggregate adjusted basis of the properties transferred to Y ( $\$120 + \$160 + \$220 = \$500$ ) exceeds their aggregate fair market value ( $\$70 + \$110 + \$240 = \$420$ ). As a result, the assets have a total net built-in loss of \$80. Under paragraph (b)(6) of this section, section 362(e)(2) does not apply to this transfer of property because X distributes all of the Y stock received in the exchange without recognizing gain or loss under section 361(c), and, upon completion of the transaction, no person holds Y stock or any other asset with a basis determined in whole or in part by reference to X's basis in the Y stock received in the exchange. A's basis in the Y stock is determined under section 358 by reference to his basis in the X stock he surrenders.

(iii) Section 355(e). (A) The facts are the same as in paragraph (i) of this Example 4, except that, one year after the section 355 distribution, Y is acquired pursuant to a plan, resulting in the application of section 355(e) to the transaction. X and Y do not elect to apply section 362(e)(2)(C).

(B) Analysis. Due to the application of section 355(e), section 361(c) will not apply and X will not be granted nonrecognition treatment on the distribution of the Y stock. As a result, paragraph (b)(6) of this section does not apply, and section 362(e)(2) applies to X's transfer of assets to Y. Under paragraph (b)(1) of this section, Y reduces its basis in Asset 1 and Asset 2 by the amount of the net built-in loss in the transferred assets, or \$80 ( $\$500 - \$420$ ). The \$80 basis reduction is allocated between Asset 1 and Asset 2 in proportion to their respective built-in losses. Prior to reduction, Asset 1 had a built-in loss of \$50 ( $\$120 - \$70$ ), and Asset 2 had a built-in loss of \$50 ( $\$160 - \$110$ ). As a result, the basis of Asset 1 is reduced by \$40 ( $50/100 \times \$80$ ), and the basis of Asset 2 is reduced by \$40 ( $50/100 \times \$80$ ), and Y receives Asset 1 with a basis of \$80 ( $\$120 - \$40$ ) and Asset 2 with a basis of \$120 ( $\$160 - \$40$ ).

(iv) Retained stock and securities without a section 362(e)(2)(C) election.

(A) The facts are the same as in paragraph (i) of this Example 4, except that X transfers Asset 1, Asset 2, and Asset 3 to Y in exchange for an equal amount of Y stock and Y securities. For a valid business purpose, X retains Y stock and Y securities each worth 1 percent of the total consideration. X and Y do not elect to apply section 362(e)(2)(C).

(B) Analysis. The aggregate basis of the properties transferred ( $\$120 + \$160 + \$220 = \$500$ ) exceeds their aggregate fair market value ( $\$70 + \$110 + \$240 = \$420$ ) by \$80 ( $\$500 - \$420$ ), and this section applies to the transfer. Under paragraph (b)(6) of this section, section 362(e)(2) applies to X's transfer of assets to Y in exchange for the Y stock and the Y securities to the extent X does not distribute the Y stock and Y securities without the recognition of gain or loss. Accordingly, section 362(e)(2)(A) applies to the extent property was exchanged for the retained Y stock and Y securities (2 percent of the total). Under paragraph (b)(1) of this section, Y reduces its basis in Asset 1 and in Asset 2 by 2 percent of the amount of the net built-in loss in the transferred assets (\$80), or \$1.60. The \$1.60 basis reduction is allocated between Asset 1 and Asset 2 in proportion to their respective built-in losses before reduction under paragraph (b)(1) of this section. Prior to reduction, Asset 1 had a built-in loss of \$50 ( $\$120 - \$70$ ), and Asset 2 had a built-in loss of \$50 ( $\$160 - \$110$ ). As a result, the basis of Asset 1 is reduced by \$.80 ( $50/100 \times \$1.60$ ), the basis of Asset 2 is reduced by \$.80 ( $50/100 \times \$1.60$ ), and Y receives Asset 1 with a basis of \$119.20 ( $\$120 - \$.80$ ) and Asset 2 with a basis of \$159.20 ( $\$160 - \$.80$ ).

(v) Retained stock and securities with a section 362(e)(2)(C) election.

(A) The facts are the same as in paragraph (iv)(A) of this Example 4, except that X and Y elect to apply section 362(e)(2)(C) to reduce X's basis in its retained Y stock and retained Y securities.

(B) Analysis. Under paragraph (b)(6) of this section, section 362(e)(2) applies to X's transfer of assets to Y in exchange for the Y stock and the Y securities to the extent X does not distribute the Y stock and Y securities without the recognition of gain or loss. Under paragraph (c) of this section, the election to apply section 362(e)(2)(C) applies to both the retained Y stock and the retained Y securities. Accordingly, under paragraph (c)(3) of this section, X reduces its basis in the retained Y stock and the retained Y securities by the amount Y would have been required to reduce its basis in the transferred assets had the election to apply section 362(e)(2)(C) not been made. As described in paragraph (iv)(B) of this Example 4, under paragraphs (b)(1) and (b)(6) of this section, Y would have been required to reduce its basis in the transferred assets by \$1.60. Accordingly, X is required to reduce its basis in the retained Y stock and Y securities by \$1.60, and, under paragraph (c)(4) of this section, this \$1.60 basis reduction is allocated between the retained Y stock and Y securities in proportion to fair market value. Because X retained Y stock and Y securities with

equal values, X holds the retained Y stock with an adjusted basis of \$1.70  $((\$500/2) \times .01) - \$0.80$  and the retained Y securities with an adjusted basis of \$1.70  $((\$500/2) \times .01) - \$0.80$ .

Example 5. Transfer of contingent liabilities subject to section 358(h)(2)(A) with section 362(e)(2)(C) election. (i) Facts. Corporation P owns Asset 1 with a basis of \$800 and a fair market value of \$700. Asset 1 constitutes a trade or business for purposes of section 358(h)(2)(A). Contingent liabilities of \$200 are associated with the Asset 1 business. P transfers Asset 1 to newly formed corporation S in exchange for all of the S stock and assumption of the contingent liabilities in a transaction qualifying under section 351. P and S elect to apply section 362(e)(2)(C).

(ii) Analysis. Under section 362(a), S would otherwise receive Asset 1 with a basis of \$800, which exceeds its fair market value of \$700. As a result, Asset 1 has a net built-in loss of \$100, and this section applies to the transfer. Under paragraph (c)(3) of this section, P reduces its basis in the S stock received by the amount S would have been required to reduce its basis in Asset 1 had the election to apply section 362(e)(2)(C) not been made (\$100). Accordingly, A receives S stock with an aggregate basis of \$700, and, under section 362(a), S receives Asset 1 with a basis of \$800.

Example 6. Property transfer qualifying under section 351 with boot  
(i) Facts. Individual A owns Asset 1 with a basis of \$80 and a fair market value of \$100, and Asset 2 with a basis of \$30 and a fair market value of \$25. In a transaction qualifying under section 351, A transfers Asset 1 and Asset 2 to newly formed corporation N in exchange for 10 shares of N stock and \$25. A and N do not elect to apply section 362(e)(2)(C) to reduce A's basis in the N stock received.

(ii) Analysis. Under paragraph (b)(4)(iii) of this section, for purposes of determining whether the transferred property has a net built-in loss in the hands of the transferee, the transferee's basis in the transferred property must be adjusted for any gain recognized by the transferor on the transfer. Section 351(b) requires transferors in transactions otherwise qualifying under section 351(a) for nonrecognition treatment to recognize gain (but not loss) to the extent the transferor receives other property or money in addition to the stock permitted to be received. For purposes of computing the amount of gain recognized under section 351(b), the consideration is allocated pro rata among the transferred properties according to their fair market values. As a result, to compute the amount of gain recognized on the transfer, A is treated as having received eight shares of N stock and \$20 in exchange for Asset 1, and two shares of N stock and \$5 in exchange for Asset 2. Under section 351(b), A must recognize \$20 of gain for the cash received in exchange for Asset 1. Thus, under section 362(a), N would otherwise have a basis of \$100 in Asset 1 and \$30 in Asset 2. N's total basis in Asset 1 and Asset 2 of \$130  $(\$100 + \$30)$  would exceed the total fair

market value of Asset 1 and Asset 2 of \$125 (\$100 + \$25). As a result, this section applies to the transfer. Under paragraph (b)(1) of this section, N reduces its basis in Asset 2 by \$5 to \$25 and, under section 362(a), takes a basis in Asset 1 of \$100. Under section 358(a), A receives N stock with a basis of \$105.

Example 7. Property transfer subject to both sections 362(e)(1) and 362(e)(2). (i) Facts. Foreign corporation FP transfers Asset 1 and Asset 2 to a domestic corporation DS in a transaction that qualifies under section 351. Asset 1 is not property described in section 362(e)(1)(B) and has a basis of \$80 and a fair market value of \$50. Asset 2 is property described in section 362(e)(1)(B) and has a basis of \$120 and a value of \$110. Section 367(b) does not apply to the transfer of Asset 1 or Asset 2.

(ii) Analysis. Under paragraphs (b)(1) and (b)(3) of this section, a transfer is described in section 362(e)(1), and thus not subject to this section, only if and to the extent there is a transfer of property described in section 362(e)(1)(B) that otherwise would have a net built-in loss in the hands of the transferee. Because Asset 2 is property described in section 362(e)(1)(B) and DS would otherwise receive Asset 2 with a basis of \$120 and a value of \$110, FP's transfer of property to DS is described in section 362(e)(1) only to the extent of the transfer of Asset 2. Asset 1 is not property described in section 362(e)(1)(B), and under section 362(a), DS would receive Asset 1 with a basis (\$80) in excess of its fair market value (\$50). Accordingly, this section applies solely to the transfer of Asset 1. Under paragraph (b)(1) of this section, DS reduces its basis in Asset 1 by \$30 to \$50. Under section 358(a), FP receives the DS stock with a basis of \$200.

Example 8. Section 304 sale of built-in loss stock. (i) Facts. Individual A owns all the stock of corporation X and corporation Y. A sells all his X stock to Y for \$60. Under section 304, A is treated as though he transferred the X stock to Y in exchange for Y stock in a transaction to which section 351 applies. Then, Y is treated as redeeming the Y stock it was treated as having issued to A in the section 351 transaction. At the time of the transaction, A holds X stock with a basis of \$90 and a fair market value of \$60. A and Y do not elect to apply section 362(e)(2)(C) to reduce A's basis in the Y stock deemed received.

(ii) Analysis. Under section 362(a), Y would otherwise receive X stock with an aggregate basis of \$90, which exceeds its aggregate fair market value of \$60. As a result, the X stock has a net built-in loss of \$30, and, under paragraph (b)(1) of this section, Y reduces its basis in the X stock received by \$30 to \$60. Under section 358(a), A receives the deemed issued Y stock with a basis of \$90.

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

Par. 5. Section 1.705-1(a)(9) is added to read as follows:

§1.705-1 Determination of basis of partner's interest.

(a) \*\*\*

(9) For basis adjustments necessary to coordinate sections 705 and 362(e)(2), see §1.362-4(c)(6).

\* \* \* \* \*

Par. 6. In §1.1367-1, a new sentence is added at the end of paragraph (c)(2) to read as follows:

§1.1367-1 Adjustments to basis of shareholder's stock in an S corporation.

\* \* \* \* \*

(c) \*\*\*

(2) \*\*\* For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see §1.362-4(c)(7).

\* \* \* \* \*

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.