[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-137573-07]

RIN 1545-BH20

Guidance under Section 1502; Amendment of Matching Rule for Certain Gains on Member Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations concerning the treatment of certain intercompany gains with respect to member stock within a consolidated group. The text of those regulations also serves as the text of these proposed regulations. These regulations affect corporations filing consolidated returns.

DATES: Written or electronic comments and requests for a public hearing must be received by June 5, 2008.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-137573-07), 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-137573-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-137573-07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John F. Tarrant or Ross E. Poulsen, (202) 622-7790; concerning submission of comments and/or requests for a public hearing, Kelly Banks, (202) 622-0932 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend the Income Tax Regulations (26 CFR part 1) under section 1502 relating to the filing of consolidated returns. The temporary regulations revise §1.1502-13(c)(6)(ii)(C) to provide for the redetermination of an intercompany gain as excluded from gross income in certain member stock transactions. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily affect affiliated groups of corporations, which tend to be larger businesses. Moreover, the number of taxpayers affected is minimal and the regulations provide relief in certain narrow circumstances. Therefore, a Regulatory Flexibility

Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 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. In particular, the IRS and Treasury Department do not foresee situations in which it should be necessary to invoke §1.1502-13(c)(6)(ii)(C) (the "Commissioner's Discretionary Rule") with respect to intercompany gain on property other than stock. Nevertheless, the IRS and Treasury Department request comments on whether any such situations are not appropriately addressed by other provisions of §1.1502-13. The Commissioner's Discretionary Rule will be retained while the IRS and Treasury Department consider such comments. However, absent compelling comments, the IRS and Treasury Department anticipate ultimately eliminating the Commissioner's Discretionary Rule. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is John F. Tarrant, Office of Associate Chief Counsel (Corporate). 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 1.1502-13 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502-13 is amended by revising paragraphs (c)(6)(ii)(C), (f)(7)(i) and (f)(7)(ii)(A) to read as follows:

§1.1502-13 Intercompany transactions.

(c) * * *

(6) * * *

(ii) * * *

(C) [The text of proposed §1.1502-13(c)(6)(ii)(C) is the same as the text of §1.1502-13T(c)(6)(ii)(C) published elsewhere in this issue of the **Federal Register**].

(1) [The text of proposed §1.1502-13(c)(6)(ii)(C)(1) is the same as the text of §1.1502-13T(c)(6)(ii)(C)(1) published elsewhere in this issue of the **Federal Register**].

(C)(2) [The text of proposed §1.1502-13(c)(6)(ii)(C)(2) is the same as the text of §1.1502-13T(c)(6)(ii)(C)(2) published elsewhere in this issue of the **Federal Register**].

(C)(2)(i) [The text of proposed §1.1502-13(c)(6)(ii)(C)(2)(i) is the same as the text of §1.1502-13T(c)(6)(ii)(C)(2)(i) published elsewhere in this issue of the **Federal Register**].

* * * * *

(f) * * *

(7) [The text of proposed §1.1502-13(f)(7) is the same as the text of §1.1502-13T(f)(7) published elsewhere in this issue of the **Federal Register**].

(i) [The text of proposed §1.1502-13(f)(7)(i) is the same as the text of §1.1502-13T(f)(7)(i) published elsewhere in this issue of the **Federal Register**].

(ii) [The text of proposed §1.1502-13(f)(7)(ii) is the same as the text of §1.1502-13T(f)(7)(ii) published elsewhere in this issue of the **Federal Register**].

(A) [The text of proposed §1.1502-13(f)(7)(ii)(A) is the same as the text of §1.1502-13T(f)(7)(ii)(A) published elsewhere in this issue of the **Federal Register**].

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/s/ Linda E. Stiff

Deputy Commissioner for Services and Enforcement.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9383]

RIN 1545-BH21

Guidance under Section 1502; Amendment of Matching Rule for Certain Gains on Member Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations concerning the treatment of certain intercompany gain with respect to consolidated group member stock. These regulations revise §1.1502-13(c)(6)(ii)(C) to provide for the redetermination of an intercompany gain as excluded from gross income in certain member stock transactions. These regulations affect corporations filing consolidated

returns. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on March 7, 2008.

Applicability Date: For dates of applicability, see §1.1502-13T(c)(6)(ii)(C)(2) and (f)(7)(ii).

FOR FURTHER INFORMATION CONTACT John F. Tarrant or Ross E. Poulsen, (202) 622-7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 1.1502-13 provides rules governing the timing and characterization of items resulting from transactions between consolidated group members. Section 1.1502-13(c) provides general rules under which the timing and character of such items can be deferred or recharacterized to clearly reflect the taxable income (and tax liability) of the group as a whole. These rules generally apply a "matching" principle under which, in a property transaction, the seller's (S) timing is linked to the buyer's (B) use of its basis in the property and S and B's characterizations are subject to redetermination in order to effectuate single entity principles.

Section 1.1502-13(c)(6)(i) provides a general rule that S's intercompany item might be redetermined under §1.1502-13(c)(1)(i) to be excluded from gross income or treated as a noncapital, nondeductible amount where B's corresponding item is excluded or nondeductible. However, §1.1502-13(c)(6)(ii) provides that, notwithstanding the general rule in paragraph (c)(1)(i), S's intercompany income or gain

is redetermined to be excluded from gross income only to the extent it involves one of three specific situations. S's intercompany income or gain is redetermined to be excluded from gross income to the extent B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under §1.1502-13, it is permanently and explicitly disallowed under another provision of the Internal Revenue Code or regulations. §1.1502-13(c)(6)(ii)(A). For this purpose, an amount is not permanently and explicitly disallowed to the extent that, among other things, the Internal Revenue Code or regulations provide that the amount is not recognized (for example, a loss that is realized but not recognized under section 332 or section 355(c)). §1.1502-13(c)(6)(ii)(A)(1). S's intercompany income or gain is redetermined to be excluded from gross income to the extent B's corresponding item is a loss that is realized but not recognized under section 311(a) on a distribution to a nonmember. §1.1502-13(c)(6)(ii)(B). Finally, S's intercompany item of income or gain is redetermined to be excluded from gross income to the extent "the Commissioner determines that treating S's intercompany item as excluded from gross income is consistent with the purposes of §1.1502-13 and other provisions of the Internal Revenue Code and regulations." §1.1502-13(c)(6)(ii)(C).

The IRS has received ruling requests asking the Commissioner to determine that S's gain with respect to member stock should be redetermined as excluded from gross income, as described in §1.1502-13(c)(6)(ii)(C). In considering these requests, the IRS has concluded that the principles set out in §1.1502-13(c)(6)(ii)(C) guiding the Commissioner's exercise of discretion are not clear enough to justify the redetermination of such gain as excludible. In the context of gain with respect to

member stock, the intercompany transaction regulations, and the consolidated return regulations in general, reflect a balancing of single and separate entity concerns. Gain with respect to member stock is often derivative and duplicative of potential gain with respect to the member's underlying assets. The consolidated return regulations permit but do not require the mitigation of this duplication. In many instances, the allowed mitigation is tailored very narrowly to protect against any possible implication of other consolidated return policies. See §§1.1502-13(c)(6)(ii)(A), 1.1502-13(f)(5), and 1.1502-13(f)(6). Thus, for example, although §1.1502-13(a) provides that the purpose of the intercompany transaction rules is to clearly reflect the taxable income of the group as a whole (which includes the elimination of duplicated gain), §1.1502-13(c)(6)(ii)(A)(1) explicitly contemplates possible gain duplication where S's intercompany item is taken into account due to a section 332 or section 355(c) transaction. Accordingly, the IRS generally does not foresee situations in which it would exercise its discretion to redetermine intercompany gain on member stock to be excludible under §1.1502-13(c)(6)(ii)(C).

The IRS and Treasury Department also do not foresee situations in which it should be necessary to invoke §1.1502-13(c)(6)(ii)(C) (the "Commissioner's Discretionary Rule") with respect to intercompany gain on property other than stock. Nevertheless, in the Proposed Rules section in this issue of the **Federal Register** (REG-137573-07), the IRS and Treasury Department request comments on whether any such situations are not appropriately addressed by other provisions of §1.1502-13. The Commissioner's Discretionary Rule will be retained while the IRS and Treasury Department consider such comments. However, absent compelling comments, the IRS

and Treasury Department anticipate ultimately eliminating the Commissioner's Discretionary Rule.

The IRS and Treasury Department, however, have identified one additional situation in which it would be appropriate to allow the exclusion of intercompany gain with respect to member stock. Accordingly, these temporary regulations redesignate current §1.1502-13(c)(6)(ii)(C) as §1.1502-13(c)(6)(ii)(D) and add a new specific exception to the rule limiting redetermination of intercompany income or gain in §1.1502-13(c)(6)(ii). This new rule has the advantage of clarity, and avoids requiring the IRS to exercise its discretion on an ad hoc basis.

Explanation of Provisions

These temporary regulations provide a rule under which, notwithstanding §1.1502-13(c)(6)(ii)(A)(1), an intercompany gain with respect to member stock is redetermined to be excluded from gross income to the extent that (1) such gain is the common parent's (P) intercompany item, (2) immediately before the intercompany gain is taken into account, P holds the member stock with respect to which the intercompany gain was realized, (3) P's basis in such member stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and that basis is not further reflected in the basis of any successor asset), (4) the group has not and will not derive any Federal income tax benefit from the intercompany transaction that gave rise to such intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under §1.1502-32), and (5) the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return. For this purpose, the

redetermination of P's intercompany gain is not in and of itself a Federal income tax benefit that would preclude redetermination under this rule.

The purpose of the provision is to prevent the effective duplication of gain within a consolidated group that would result from taking an intercompany gain into account without any corresponding tax basis (or other resulting tax benefit). The provision's five requirements are intended to ensure that any intercompany gain with respect to member stock may only be redetermined to be excluded from gross income to the extent that it is not reflected in basis after the transaction (or does not result in some other tax benefit). Accordingly, where some tax benefit has been derived from the intercompany transaction, a portion of the intercompany gain may still be redetermined to be excluded from gross income to the extent that no additional tax benefits were or would be derived and the provision's other requirements are satisfied. See §1.1502-13T(f)(7)(i) Example 8.

For this purpose, the term "Federal income tax benefit" is intended to be construed broadly. For example, the term includes, but is not limited to, the reduction of an excess loss account that would otherwise be taken into account in the transaction. The effects of the intercompany transaction may be reflected on the group's consolidated return, for example, to the extent that any increase in the basis of the member's stock as a result of the intercompany transaction is taken into account and alters the reduction of any member's attributes under sections 108 and 1017 and §1.1502-28.

In the Proposed Rules section in this issue of the **Federal Register** (REG-137573-07), the IRS and Treasury Department are requesting comments as to whether

the rule should be broadened to apply to additional situations that would result in the effective duplication of gain. For example, should the rule be broadened to apply to other transactions involving member stock, or similar transactions involving nonmember stock?

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined, pursuant to 5 U.S.C. 553(b)(B), that good cause exists for dispensing with the notice and public comment procedures and that, pursuant to 5 U.S.C. 553(d)(3), good cause exists to dispense with a delayed effective date. The regulations are necessary to provide immediate guidance and relief to taxpayers regarding certain intercompany gains with respect to member stock. For the applicability of the Regulatory Flexibility Act refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is John F. Tarrant, Office of Associate Chief Counsel (Corporate). 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.

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

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

Section 1.1502-13T also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502-13 is amended as follows:

1. Paragraph (c)(6)(ii)(C) is redesignated as (c)(6)(ii)(D).

2. Paragraph (c)(6)(ii)(C) is added.

3. Paragraph (f)(7) is redesignated as paragraph (f)(7)(i) and a new paragraph heading is added.

4. Newly-designated paragraph (f)(7)(i) Examples 7 and 8, and paragraph (f)(7)(ii) are added.

The revisions and additions read as follows:

§1.1502-13 Intercompany transactions.

* * * * *

(c) * * *

(6) * * *

(ii) * * *

(C) [Reserved]. For further guidance, see §1.1502-13T(c)(6)(ii)(C).

* * * * *

(f) * * *

(7) Examples--(i) In general. * * *

* * * * *

Example 7 [Reserved]. For further guidance, see §1.1502-13T(f)(7)(i) Example 7.

Example 8 [Reserved]. For further guidance, see §1.1502-13T(f)(7)(i) Example 8.

(ii) [Reserved]. For further guidance, see §1.1502-13T(f)(7)(ii).

Par. 3. Section 1.1502-13T is added to read as follows:

§1.1502-13T Intercompany transactions (temporary).

(a) through (c)(6)(ii)(B) [Reserved]. For further guidance, see §1.1502-13(a) through (c)(6)(ii)(B).

(C) Certain intercompany gains on member stock--(1) In general. Notwithstanding §1.1502-13 (c)(6)(ii)(A)(1), intercompany gain with respect to member stock is redetermined to be excluded from gross income to the extent that--

(i) The gain is the common parent's (P) intercompany item;

(ii) Immediately before the intercompany gain is taken into account, P holds the member stock with respect to which the intercompany gain was realized;

(iii) P's basis in such member stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and such eliminated basis is not further reflected in the basis of any successor asset);

(iv) The group has not and will not derive any Federal income tax benefit from the intercompany transaction that gave rise to such intercompany gain or the

redetermination of the intercompany gain (including any adjustment to basis in member stock under §1.1502-32); and

(v) The effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return. For this purpose, the redetermination of the intercompany gain is not in and of itself considered a Federal income tax benefit.

(2) Effective/applicability date--(i) In general. This paragraph (c)(6)(ii)(C) applies with respect to items taken into account on or after March 7, 2008.

(ii) Expiration date. The applicability of this paragraph (c)(6)(ii)(C) will expire on March 4, 2011.

(c)(6)(ii)(D) through (f)(7)(i) Example 6 [Reserved]. For further guidance, see §1.1502-13(c)(6)(ii)(D) through (f)(7)(i) Example 6.

Example 7. Intercompany stock sale followed by section 332 liquidation into common parent. (i) Facts. P owns all of the stock of S, S owns all the stock of T, and T owns all of the stock of T1. On January 1 of Year 1, S distributes all of the T stock to P in a distribution to which section 301 applies. At the time of this distribution, the value of the T stock is $100 and S has a $40 basis in the T stock. Under section 311(b), S recognizes a $60 gain. Under section 301(d), P's basis in the T stock is $100. S will take its $60 gain into account under the matching rule in paragraph (c) of this section. On January 1 of Year 4, in an independent transaction, S distributes all of its assets to P in a complete liquidation to which section 332 applies, and, under paragraph (j)(2) of this section, P succeeds to S's $60 gain. On January 1 of Year 7, T distributes all of its T1 stock to P in a transaction to which section 355 applies. At the time of this distribution, P has a basis in the T stock of $100, the value of the T stock (without regard to T1) is $75, and the value of the T1 stock is $25. Under section 358, P allocates $25 of its $100 basis in the T stock to the T1 stock, and, under paragraph (j)(1) of this section, the T1 stock becomes a successor asset to the T stock. On January 1 of Year 9, in an independent transaction, when T's assets have a value of $75, T distributes all of its assets to P in a complete liquidation to which section 332 applies.

(ii) Analysis. Under paragraphs (b)(1) and (f)(2) of this section, S's distribution of the T stock to P is an intercompany transaction, S is the selling member, and P is the buying member. In Year 9 when T liquidates, P has $0 of unrecognized gain or loss

under section 332 because P has a $75 basis in the stock of T and receives a $75 distribution with respect to its T stock. Under paragraph (b)(3)(ii) of this section, P's $0 of unrecognized gain or loss with respect to the T stock under section 332 is a corresponding item. P takes $45 of its intercompany gain into account under the matching rule in Year 9 to reflect the difference between P's $0 of unrecognized gain and P's $45 of recomputed unrecognized gain. (If P and S were divisions of a single corporation, P would have had a $40 basis in the T stock, and, after the Year 7 distribution of the T1 stock, would have held the T stock with a $30 basis.) Paragraph (c)(6) of this section does not prevent the redetermination of P's intercompany gain as excluded from gross income to the extent that the gain is P's intercompany item, P holds the T stock with respect to which this portion of the intercompany gain was realized, P's basis in the T stock that reflects the $45 intercompany gain taken into account is eliminated without the recognition of gain or loss (and this eliminated basis is not further reflected in the basis of any successor asset), the group has not derived any Federal income tax benefit from the basis in the T stock and will not derive any Federal income tax benefit from a redetermination of this portion of the gain, and the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the P group's consolidated return. (See paragraph (c)(6)(ii)(C) of this section). Accordingly, under paragraph (c)(6)(ii)(C) of this section, the $45 intercompany gain that P takes into account is redetermined to be excluded from gross income.

Example 8. Intercompany stock sale followed by section 355 distribution by the common parent. (i) Facts. The facts are the same as Example 7, except that T does not distribute the stock of T1, instead, in Year 7, T makes a distribution of $50 to P in transaction to which section 301 applies. Under §1.1502-32, P's basis in its T stock is reduced by $50 and, under paragraph (f)(2)(ii) of this section, the intercompany distribution is excluded from P's gross income. Further, in Year 9, instead of liquidating T, P distributes the T stock to its shareholders in a transaction to which section 355 applies.

(ii) Analysis. On the distribution of the T stock, P has $0 of unrecognized gain under section 355(c) because P's has a $50 basis in the stock of T which has a value of $50. Under paragraph (b)(3)(ii) of this section, P's $0 of unrecognized gain or loss with respect to the T stock under section 355(c) is a corresponding item. P takes its $60 intercompany gain into account under the matching rule in Year 9 to reflect the difference between P's $0 of unrecognized gain and P's $60 of recomputed gain ($50 unrecognized gain and $10 recognized gain). (If P and S were divisions of a single corporation, P would have had a $40 basis in the T stock, and, after the Year 7 distribution, would have held the T stock with a $10 excess loss account.) Paragraph (c)(6) of this section does not prevent the redetermination of P's intercompany gain as excluded from gross income to the extent that the gain is P's intercompany gain, P holds the T stock with respect to which this portion of the intercompany gain was realized, P's basis in the T stock that reflects the $60 intercompany gain taken into account is eliminated without the recognition of gain or loss (and this eliminated basis is not further reflected in any successor asset), the group has not derived any Federal income tax benefit from the basis in the T stock and will not derive any Federal income

tax benefit from a redetermination of this portion of the gain, and the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the P group's consolidated return. (See paragraph (c)(6)(ii)(C) of this section). The intercompany transaction with respect to the T stock resulted in an increase in the basis of the T stock, and this increase in the basis of the T stock prevented P from holding the T stock with a $10 excess loss account (as a result of the Year 7 distribution) at the time of the section 355 distribution. Accordingly, the group derived a Federal income tax benefit from the intercompany transaction to the extent of $10. As such, under paragraph (c)(6)(ii)(C) of this section, only $50 of the $60 intercompany gain that P takes into account is redetermined to be excluded from gross income.

(iii) Application of section 355(e). If it was determined that section 355(e) applied to P's distribution of the T stock, P would recognize $0 of gain and derive a Federal income tax benefit to the extent of the full $60 increase in the basis of the T stock. Therefore, no portion of P's intercompany gain would be redetermined to be excluded from gross income under paragraph (c)(6)(ii)(C) of this section.

(ii) Effective/applicability date--(A) In general. Paragraph (f)(7)(i) Examples 7 and 8 of this section apply with respect to items taken into account on or after March 7, 2008.

(B) Expiration date. The applicability of paragraph (f)(7)(i) Examples 7 and 8 of this section will expire on March 4, 2011.

(g) through (m) [Reserved]. For further guidance, see §1.1502-13(g) through (m).

/s/ Linda E. Stiff

Deputy Commissioner for Services and Enforcement.

Approved: March 3, 2008

/s/ Eric Solomon

Assistant Secretary of the Treasury (Tax Policy).