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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9498]

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Application of Section 108(i) to Partnerships and S Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the application of section 108(i) of the Internal Revenue Code (Code) to partnerships and S corporations and provides rules regarding the deferral of discharge of indebtedness income and original issue discount deductions by a partnership or an S corporation with respect to reacquisitions of applicable debt instruments after December 31, 2008, and before January 1, 2011. The regulations affect partnerships and S corporations with respect to reacquisitions of applicable debt instruments and their partners and shareholders. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Notice of Proposed Rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §1.108(i)-0T(b).

FOR FURTHER INFORMATION CONTACT: Megan A. Stoner or Joseph R. Worst, Office of Associate Chief Counsel (Passthroughs and Special Industries), (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these temporary regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-2147. The collection of information in these temporary regulations is in §1.108(i)-2T(b)(3)(iv). Under §1.108(i)-2T(b)(3)(iv), a partner in a partnership that makes an election under section 108(i) is required to provide certain information to the partnership so that the partnership can correctly determine the partner's deferred section 752 amount with respect to an applicable debt instrument.

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

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1231 of the American Recovery and Reinvestment Tax Act of 2009, Pub. L. 111-5 (123 Stat. 338 (2009)), added section 108(i) to the Code. Section 108(i)

generally provides for an elective deferral of discharge of indebtedness income (COD income) realized by a taxpayer from a reacquisition of an applicable debt instrument that occurs after December 31, 2008, and before January 1, 2011. COD income deferred under section 108(i) is included in gross income ratably over a five taxable-year period (inclusion period) beginning with the taxpayer's fourth or fifth taxable year following the taxable year of the reacquisition. In circumstances where a debt instrument is issued (or treated as issued) as part of the reacquisition, some or all of any original issue discount (OID) expense accruing from the debt instrument in a taxable year prior to the first taxable year of the inclusion period may also be required to be deferred (deferred OID deduction). The aggregate amount of deferred OID deductions is limited to the amount of COD income deferred with respect to the applicable debt instrument for which the section 108(i) election is made and the aggregate amount of deferred OID deductions is taken into account ratably over the inclusion period. In general, COD income deferred under section 108(i) and related deferred OID deductions with respect to an applicable debt instrument that have not been previously taken into account (deferred items) are accelerated and taken into account in the taxable year in which an acceleration event occurs. A section 108(i) election is irrevocable and, if a section 108(i) election is made, sections 108(a)(1)(A), (B), (C), and (D) do not apply to the COD income that is deferred under section 108(i). Section 108(i)(7) authorizes the Secretary to prescribe regulations as may be necessary or appropriate for purposes of applying section 108(i).

After section 108(i) was enacted, the IRS and the Treasury Department received a number of comments regarding the application of section 108(i) to partnerships and

S corporations. In August 2009, the IRS and the Treasury Department issued Rev. Proc. 2009-37 (2009-36 IRB 309), which provides election procedures for taxpayers (including partnerships and S corporations) and other guidance under section 108(i). With respect to COD income realized by a partnership or S corporation, the election is made at the entity level. Partnerships and S corporations that make an election under section 108(i) (electing partnership or electing S corporation) must follow the election procedures and reporting requirements of Rev. Proc. 2009-37.

These temporary regulations address issues relating to partnerships and S corporations with respect to section 108(i), including issues raised by commenters.

Explanation of Provisions

A. Applicable Debt Instrument

Section 108(i)(3) defines an “applicable debt instrument” as any debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by that person. The determination of whether a debt instrument is an applicable debt instrument within the meaning of section 108(i)(3) is based on all the facts and circumstances.

Section 1.108(i)-2T(d)(1) provides five safe harbors under which a debt instrument issued by a partnership or an S corporation is deemed to be issued in connection with the partnership’s or S corporation’s trade or business for purposes of section 108(i). Thus, a debt instrument issued by a partnership or an S corporation qualifies as an applicable debt instrument for purposes of section 108(i) if the electing partnership or electing S corporation can establish that it meets the requirements of one of the safe harbors.

Some commenters asked whether a debt instrument issued by a non-C corporation taxpayer to acquire an interest in a partnership or S corporation that is conducting a trade or business qualifies as an applicable debt instrument, where the issuing taxpayer does not conduct a trade or business. While a debt instrument generally does not qualify as an applicable debt instrument unless the issuing taxpayer conducts a trade or business, one of the safe harbors under §1.108(i)-2T(d)(1) provides that if an electing partnership or an electing S corporation can establish that at least 95 percent of the interest paid or accrued on a debt instrument issued by a partnership or S corporation was allocated to a trade or business expenditure under §1.163-8T for the taxable year of issuance, then the debt instrument qualifies as an applicable debt instrument for purposes of section 108(i).

Commenters also asked how a debt instrument issued by a disregarded entity should be treated under section 108(i). Generally, under §301.7701-2 of the Procedure and Administration Regulations, if an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. Thus, for purposes of determining whether a debt instrument qualifies as an applicable debt instrument under section 108(i), a debt instrument issued by a disregarded entity is treated as a debt instrument issued by the person treated as owning the assets of the disregarded entity for federal income tax purposes.

B. Allocation of COD Income

Section 108(i)(6) requires that a partnership allocate the COD income that is deferred under section 108(i) to the partners that were partners immediately prior to the transaction giving rise to the COD income in the same manner the income would be

allocated without regard to section 108(i). In addition, section 108(i)(5)(B)(iii) provides that the section 108(i) election is to be made by the partnership and not its partners separately. The IRS and the Treasury Department recognize that there are instances in which the inclusion of COD income would be beneficial to some partners, but not to others. As a result, the temporary regulations, while not changing the general rules under section 704, permit a partnership to determine the portion of each partner's allocable share of COD income resulting from a reacquisition of an applicable debt instrument that is deferred under section 108(i) (deferred amount) and the portion that is not deferred (included amount). The temporary regulations therefore require that the electing partnership first allocate all of the COD income with respect to an applicable debt instrument to its partners that are partners in the partnership immediately before the reacquisition in the manner in which the income would be included in the distributive shares of the partners under section 704 and the regulations under section 704, including §1.704-1(b)(2)(iii), without regard to section 108(i). The partnership must then determine the portion of each such partner's allocable share of the COD income from the applicable debt instrument that is the deferred amount, and the portion that is the included amount and therefore included in the partner's distributive share of partnership income for the taxable year of the partnership in which the reacquisition occurs.

With respect to S corporations, section 108(i) requires that the election to defer COD income be made at the corporate level. Section 108(i) does not, however, impose a specific allocation rule with respect to the COD income realized by an electing S corporation from the reacquisition of an applicable debt instrument as it does for electing partnerships. The IRS and the Treasury Department believe that a rule similar

to the partnership allocation rule under section 108(i)(6) should apply to electing S corporations. Therefore, §1.108(i)-2T(c)(1) requires that the deferred COD income of an electing S corporation be shared pro rata, on the basis of stock ownership, among those shareholders that hold stock in the electing S corporation immediately prior to the transaction giving rise to the COD income.

C. Basis Adjustments

Commenters asked whether a partner is required to adjust the basis in its partnership interest under section 705 in the year of the reacquisition to account for the partner's share of deferred COD income, or whether such adjustments occur when the deferred items are recognized. In general, a partner's basis in its partnership interest is increased under section 705(a) to account for the partner's share of partnership COD income in the taxable year that the COD income is realized by the partnership. If a partnership elects to defer its COD income under section 108(i), however, a partner's basis in its partnership interest is not increased under section 705(a) to account for the partner's deferred amount in the taxable year that the COD income is realized, but rather is adjusted in the taxable year that the partner recognizes the deferred amount. Because a partner does not adjust its basis for deferred COD income in the taxable year of a reacquisition, a partner could recognize gain under section 731(a) in that taxable year if the decrease in the partner's share of partnership liabilities exceeds the partner's basis in its partnership interest. Congress anticipated this result and created a special deferral rule in section 108(i)(6).

Section 108(i)(6) provides that any decrease in a partner's share of partnership liabilities as a result of the discharge shall not be taken into account for purposes of

section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731. If a partner were to increase the basis in its partnership interest to account for the deferred COD income at the time of the reacquisition, the special deferral rule in section 108(i)(6) would not be needed. Therefore, consistent with the rule in section 108(i)(6), §1.108(i)-2T(b)(2) provides that a partner's basis in its partnership interest is not adjusted under section 705(a) to account for the partner's share of the partnership's deferred items at the time of the reacquisition, but is adjusted when the deferred items are recognized, either during the recognition period or as a result of an acceleration event. When the partner's share of the partnership's deferred items is recognized due to an acceleration event, the partner must adjust the basis in its partnership interest under section 705 immediately prior to the acceleration event to account for the deferred items that are recognized.

Like the basis adjustment rules for partners, an S corporation shareholder's stock basis is not adjusted under section 1367 to account for the shareholder's share of the S corporation's deferred items at the time of the reacquisition, but is adjusted when the deferred items are recognized. Moreover, an S corporation's accumulated adjustments account (AAA) is not adjusted to account for the deferred items at the time of the reacquisition, but is adjusted in the taxable year in which the deferred items are recognized.

D. Deferred Section 752 Amount Rules

Section 2.09 of Rev. Proc. 2009-37 provides general guidelines for a partnership to use in determining a partner's deferred section 752 amount (that is, a decrease in a partner's share of a partnership liability under section 752(b) resulting from the

reacquisition of an applicable debt instrument that is not treated as a current distribution of money to the partner under section 752(b) by reason of section 108(i)(6)). The temporary regulations include the same general rules that are set forth in Rev. Proc. 2009-37 and provide additional computational rules for determining a partner's deferred section 752 amount.

In computing a partner's deferred section 752 amount, under §1.108(i)-2T(b)(3)(ii), the electing partnership must determine the amount of gain the partner would recognize in a taxable year of a reacquisition under section 731 as a result of the reacquisition absent the deferral provided in the second sentence of section 108(i)(6). In making this determination, the basis ordering rules in section 705(a) apply and the amount of any deemed distribution of money under section 752(b), resulting from the reacquisition of an applicable debt instrument, that is treated as an advance or drawing under §1.731-1(a)(1)(ii) is determined as if no COD income resulting from the reacquisition is deferred under section 108(i). See Rev. Rul. 94-4, 1994-1 C.B. 195, and Rev. Rul. 92-97, 1992-2 C.B. 124, for rules regarding when a deemed distribution of money under section 752(b) resulting from a cancellation of debt is treated as an advance or drawing under §1.731-1(a)(1)(ii).

If the electing partnership determines that a partner would recognize gain under section 731 absent the deferral provided in the second sentence of section 108(i)(6) and the partnership makes a section 108(i) election to defer COD income from only one applicable debt instrument during the taxable year, then any deferred section 752 amount of the partner relates to that applicable debt instrument. If the partnership makes a section 108(i) election to defer COD income from more than one applicable

debt instrument during the taxable year, §1.108(i)-2T(b)(3)(iii) provides a rule for determining the portion of the partner's deferred section 752 amount that relates to each such applicable debt instrument.

Section 4.12(4) of Rev. Proc. 2009-37 provides that the deferred section 752 amount for partners in a partnership making a section 108(i) election is calculated for the electing partnership's direct partners. In circumstances where a partnership (upper-tier partnership) that is a direct or indirect partner of an electing partnership has a deferred section 752 amount with respect to an applicable debt instrument of the electing partnership, the upper-tier partnership does not need to calculate the deferred section 752 amount of its direct partners in the same manner that the electing partnership does. Instead, the upper-tier partnership that has a deferred section 752 amount shall allocate such amount among its direct partners that have a deferred amount with respect to the applicable debt instrument in proportion to the partners' respective shares of the upper-tier partnership's deferred amount. Section 1.108(i)-2T(b)(4)(ii) provides that a partner's share of an upper-tier partnership's deferred section 752 amount may not exceed the partner's deferred amount with respect to the applicable debt instrument to which the deferred section 752 amount relates.

The temporary regulations contain examples to illustrate how a partner's deferred section 752 amount should be computed. One example illustrates ordering rules in computing a partner's deferred section 752 amount if the partnership has both gross income and separately stated losses in the year of a reacquisition. Section 1.704-1(d)(2) provides rules for computing the adjusted basis of a partner's interest for

purposes of determining the extent to which a partner's distributive share of partnership loss is allowed as a deduction. The example illustrates how the deferred section 752 computational rule interacts with the rules under section 705(a) and §1.704-1(d)(2).

E. Capital Accounts

Commenters requested that guidance address how a partnership's capital account should be adjusted under §1.704-1(b)(2)(iv) to account for a partner's share of the partnership's deferred items. The IRS and the Treasury Department believe that, for capital account maintenance purposes, a partnership should treat deferred items as if no election under section 108(i) has been made. Accordingly, §1.108(i)-2T(b)(2)(ii) provides that a partner's capital account is adjusted under §1.704-1(b)(2)(iv) for the partner's share of the partnership's deferred items as if no election under section 108(i) were made.

F. Section 465(e) Recapture

Commenters requested that guidance be provided under section 465 to prevent an election under section 108(i) from triggering recapture of losses under section 465(e). Under section 465(e)(1)(A), if at the close of any taxable year a taxpayer's amount at risk in an activity is below zero, the taxpayer generally is required to include the amount of the excess in gross income. The amount required to be included in gross income, however, is limited to losses allowed in previous years that have not already been recaptured. Section 465(e)(1)(B) treats the recaptured amount as a deduction attributable to the activity in the following taxable year.

Although the second sentence of section 108(i)(6) provides for deferral of a deemed distribution under section 752 to the extent that it triggers gain to a partner

under section 731, the statute does not provide a similar rule that defers any amount at risk in an activity required to be recaptured under section 465(e). Thus, if the discharged debt for which a section 108(i) election is made has been included in a partner's amount at risk in an activity and a portion of that debt is discharged, there could be recapture under section 465(e) if the amount discharged exceeds the partner's amount at risk in the activity. The same issue may arise with respect to shareholders of an S corporation.

The IRS and the Treasury Department believe that the decrease in a partner's or shareholder's amount at risk in an activity that results from the discharge of a debt for which a section 108(i) election is made by the partnership or S corporation, as the case may be, should also be deferred to prevent the partner or shareholder from recognizing more recapture income under section 465(e) than the partner or shareholder would recognize if the section 108(i) election had not been made. Accordingly, §1.108(i)-2T(d)(3) provides that a decrease in a partner's or shareholder's amount at risk in an activity that results from a discharge of a debt for which a section 108(i) election is made is not taken into account in determining the partner's or shareholder's amount at risk in that activity under section 465 in the taxable year of the reacquisition. The decrease is taken into account at the same time and to the extent remaining in the same amount as the partner or shareholder recognizes the deferred COD income.

G. Deferral of Original Issue Discount

Under section 108(i)(2), if a debt instrument is issued (or treated as issued under section 108(e)(4)) in a debt-for-debt exchange described in section 108(i)(2)(A) or a deemed debt-for-debt exchange described in §1.108(i)-3T(a) and there is any OID on

the debt instrument, the issuer of the new debt instrument must defer some or all of the deductions for such OID under section 108(i). The temporary regulations provide that the aggregate amount of deferred OID is allowable as a deduction to the issuer of the debt instrument ratably over the inclusion period, or earlier upon the occurrence of an acceleration event.

The OID deferral rule in section 108(i)(2) applies to an issuing entity. An issuing entity includes an electing partnership or an electing S corporation that issues a debt instrument in a debt-for-debt exchange or a deemed debt-for-debt exchange and a partnership or an S corporation that is related (within the meaning of section 108(i)(5)(A)) to an electing entity (an entity that is a taxpayer that makes an election under section 108(i)) and that issues a debt instrument in a debt-for-debt exchange or a deemed debt-for-debt exchange.

The issuing entity determines whether any OID that accrues on a debt instrument in a taxable year during the deferral period is required to be deferred. For example, an electing partnership that issues a debt instrument with OID in a debt-for-debt exchange described in section 108(i)(2)(A) in which the partnership elects to defer \$100 of COD income must defer the first \$100 of OID that accrues on such debt instrument during the deferral period, even if a partner's share of the partnership's deferred OID exceeds the partner's deferred amount with respect to the applicable debt instrument.

The temporary regulations provide rules relating to basis adjustments and adjustments to AAA for deferred OID deductions that apply to the issuing entity.

H. Acceleration Events

Section 108(i)(5)(D)(i) provides that deferred items must be taken into account upon the occurrence of certain enumerated events (acceleration events) with respect to the electing partnership or electing S corporation. These events include the liquidation or sale of substantially all of the assets of the electing partnership or electing S corporation (including in a Title 11 or similar case), the cessation of business, or similar circumstances. If any of these events occurs, all of the deferred items of the electing partnership or electing S corporation are accelerated and must be taken into account by the partners and/or shareholders, as the case may be, in the taxable year of the electing partnership or electing S corporation in which such event occurs.

Section 108(i)(5)(D)(ii) contains additional acceleration events that apply to the partners and/or shareholders of an electing partnership or an electing S corporation, as the case may be, and includes the sale, exchange, or redemption of an interest in the electing partnership or electing S corporation by the holder of such interest. If any of these events occurs, the deferred items allocated to the partner or S corporation shareholder that sells, exchanges, or redeems its interest in the electing partnership or S corporation, as the case may be, are accelerated and must be taken into account by such partner or shareholder in the taxable year in which the event occurs. When an acceleration event occurs under section 108(i)(5)(D)(ii) with respect to a particular partner or an S corporation shareholder, it does not affect the continued deferral of another partner's or S corporation shareholder's share of the partnership's or S corporation's deferred items.

Section 108(i)(7) authorizes the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of applying section 108(i), including rules extending the acceleration provisions to other circumstances where appropriate. Therefore, the temporary regulations provide additional rules (and exceptions) that apply to the acceleration of deferred items under section 108(i)(5)(D).

The temporary regulations provide that the deferred items allocated to the direct and indirect partners of the electing partnership, which includes a shareholder of an S corporation that is a direct/indirect partner of an electing partnership (S corporation partner), and to the shareholder of an electing S corporation are accelerated if the electing partnership or the electing S corporation (i) liquidates, (ii) sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets, (iii) ceases doing business, or (iv) files a petition in a Title 11 or similar case. In addition, the deferred items of the shareholders of an electing S corporation or an S corporation partner are accelerated in the taxable year in which the S corporation's or S corporation partner's election under section 1362(a) is terminated. Moreover, the acceleration rules and exceptions that apply to an electing corporation under §1.108(i)-1T(b) also apply to a C corporation partner in the same manner as if the C corporation partner were an electing corporation.

The temporary regulations specify that substantially all of the partnership's or S corporation's assets means assets representing at least 90 percent of the fair market value of the partnership's or S corporation's net assets and at least 70 percent of the fair market value of the partnership's or S corporation's gross assets, as measured immediately prior to the sale, exchange, transfer, or gift in question. If an electing

partnership holds only an interest in another partnership (lower-tier partnership) and the lower-tier partnership sells its assets, the sale by the lower-tier partnership would not constitute a sale, exchange, transfer, or gift of the electing partnership's assets for purposes of applying the acceleration rules. However, the IRS and the Treasury Department believe that if an electing partnership, for example, transfers property to a partnership (transferee partnership) in a transaction governed all or in part by section 721 and the transferee partnership subsequently sells substantially all of its assets, it is appropriate to treat the electing partnership as having sold, exchanged, transferred, or gifted its entire interest in that transferee partnership for purposes of applying the acceleration rules. If, in that situation, the electing partnership's only asset is its interest in the transferee partnership, the electing partnership will be treated as selling substantially all of its assets and therefore, its deferred items would be accelerated. The principles of the substantially all rules apply to lower-tier partnerships of the electing partnership that receive assets of the electing partnership from a transferee partnership or another lower-tier partnership of the electing partnership in a transaction governed all or in part by section 721.

In addition to the electing partnership-level or electing S corporation-level events that trigger acceleration under section 108(i), certain events that occur at the partner or shareholder level also trigger acceleration of that partner's or shareholder's share of the electing partnership's or electing S corporation's deferred items. For instance, the deferred items allocated to a direct or indirect partner of an electing partnership are accelerated if: (1) the partner dies or liquidates, (2) the partner sells, exchanges (including redemptions treated as exchanges under section 302), transfers (including

contributions and distributions), or gifts (including transfers treated as gifts under section 1041) all or a portion of a separate interest, (3) the partner's separate interest is redeemed, or (4) the partner abandons its separate interest. For this purpose, a distribution by a partnership to a partner of property other than a separate interest, in a transaction that does not constitute a complete redemption of the partner's interest, does not constitute an acceleration event, even if, for example, the distribution causes gain to be recognized to the partner under section 731(a). Moreover, a shareholder's share of an electing S corporation's deferred items is accelerated if the shareholder: (1) dies, (2) sells, exchanges (including redemptions treated as exchanges under section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under section 1041) all or a portion of its interest in the electing S corporation, or (3) abandons its interest in the electing S corporation. For purposes of the temporary regulations, a "separate interest" is defined as any direct interest in an electing partnership or in a partnership or S corporation that is a direct or indirect partner of an electing partnership.

If a partner or shareholder sells, exchanges, transfers, or gifts only a portion of its interest in a partnership or an S corporation, only a proportionate amount of the partner's or shareholder's share of the partnership's or S corporation's deferred items is accelerated. For example, if a partner of an electing partnership with a \$100 deferred amount from the electing partnership sells half of its interest in the electing partnership, \$50 of the partner's \$100 share of the partnership's deferred amount is accelerated.

The temporary regulations address when a partner's separate interest is redeemed for purposes of section 108(i). Commenters suggested that a non-liquidating

distribution of cash or other property by a partnership to a partner should not be treated as a redemption under section 108(i). The IRS and the Treasury Department agree with the commenters. Difficulties in defining a redemption of a partnership interest for purposes of section 108(i) arise if non-liquidating distributions are treated as redemptions under section 108(i). The IRS and the Treasury Department believe that, for purposes of section 108(i), redemptions should be limited to cases where a partner's interest in the partnership is completely liquidated. Therefore, the temporary regulations provide that a redemption of a partner's separate interest occurs when a partner receives a distribution of cash and/or property in complete liquidation of such partner's separate interest.

The IRS and the Treasury Department believe that certain events should not cause a partner's or shareholder's share of the partnership's or S corporation's deferred items to be accelerated. For instance, if an electing partnership contributes its assets to another partnership (transferee partnership) in a transaction governed by section 721 (generally a non-recognition event to the electing partnership and the transferee partnership), the deferred items of an electing partnership can continue to be allocated to its partners under principles similar to section 704(c). Therefore, transactions wholly governed by section 721 in which a partner's or shareholder's share of the partnership's or S corporation's deferred items can continue to be allocated to that partner or shareholder are generally not acceleration events for purposes of section 108(i). These section 721 non-acceleration events include contributions by an electing partnership or an electing S corporation, contributions of an entire separate interest by direct or indirect partners of an electing partnership, and section 708(b)(2)(A) mergers or

consolidations of an electing partnership or a partnership that is a direct or indirect partner of an electing partnership.

In any of the events listed above, the general acceleration rules apply to any part of the transaction to which section 721(a) does not apply. For example, if an electing partnership merges with another partnership and one of the partners of the electing partnership elects to apply the partner buy-out rule of §1.708-1(c)(4), such partner's share of the electing partnership's deferred items is accelerated because such partner is treated as selling its interest in the electing partnership immediately before the merger. The other partners' shares of deferred items of the electing partnership are not accelerated as a result of the merger.

In addition to the section 721 non-acceleration events, like-kind exchanges of property by an electing partnership or an electing S corporation pursuant to section 1031(a) are generally not acceleration events. As in a transaction governed by section 721, a transaction governed by section 1031(a) is generally a non-recognition event. The electing partnership or electing S corporation that transfers property in the like-kind exchange can continue to allocate the partners' or shareholders' shares of the partnership's or S corporation's deferred items as if no exchange occurred. To the extent money or property which does not meet the requirements of section 1031(a) (boot) is received in the exchange, however, a portion of the transferred property will be treated as sold. Under §1.108(i)-2T(b)(6)(iii)(B) and §1.108(i)-2T(c)(3)(iii)(B), the portion of the transferred property that is treated as sold is based on the ratio of the boot to the total consideration received in the exchange. For example, if an electing partnership exchanges property with a value of \$100 and a basis of \$30 for \$80 of like-kind property

and \$20 of non-like kind property, the electing partnership is treated as if it sold 20 percent of the property transferred in the exchange. In such a case, if the portion sold constitutes substantially all of the electing partnership's assets, the electing partnership's deferred items would be accelerated under §1.108(i)-2T(b)(6)(i)(A)(2).

In addition to the section 721 and section 1031 non-acceleration events, a technical termination of an electing partnership or a partnership that is a direct or indirect partner of an electing partnership under section 708(b)(1)(B) is not an acceleration event for purposes of section 108(i). Section 708(b)(1)(B) provides that a partnership is considered as terminated if within a twelve-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Under §1.708-1(b)(4), the terminated partnership is deemed to contribute its assets and liabilities to a new partnership in exchange for an interest in the new partnership and, immediately thereafter, the terminated partnership is deemed to distribute interests in the new partnership to its partners in liquidation of their interests. As in a transaction governed by section 721, the deferred items of the terminated partnership's partners can continue to be allocated to those partners by the new partnership. The terminated partnership's business continues in the new partnership and the non-selling partners of the terminated partnership remain partners in the new partnership. The terminated partnership's section 108(i) election remains in effect for the new partnership. Therefore, a technical termination of a partnership under section 708(b)(1)(B) is not an acceleration event for purposes of section 108(i). The transfer that causes a technical termination, however, may be an acceleration event for the transferring partner.

In addition to the section 721, section 1031, and section 708(b)(1)(B) non-acceleration events, certain distributions of separate interests by a partnership (upper-tier partnership) that is a direct or indirect partner of an electing partnership are not acceleration events for purposes of section 108(i). If an upper-tier partnership distributes its entire separate interest (distributed separate interest) to one or more of its partners (distributee partners) that have a share of the electing partnership's deferred items from upper-tier partnership's distributed separate interest, the partnership, the interest in which was distributed, can continue to allocate the deferred items of any distributee partner with respect to the distributed separate interest. As a result, the distributee partner's share of the electing partnership's deferred items associated with the distributed separate interest are not accelerated, even if such distribution is in complete liquidation of that partner's interest in the upper-tier partnership. However, because the upper-tier partnership no longer holds the separate interest, the upper-tier partnership's share of the electing partnership's deferred items associated with that separate interest will be accelerated for the non-distributee partners. Further, if the distributee's partnership interest is redeemed by the upper-tier partnership, any other share of an electing partnership's deferred items associated with the redeemed separate interest in the upper-tier partnership will be accelerated and must be taken into account by the distributee partner.

Certain non-acceleration events that apply to an electing corporation also apply to C corporation partners. The exception in §1.108(i)-1T(b)(2)(ii)(B) relating to transactions governed by section 381 applies to C corporation partners. Section

1.108(i)-2T(b)(6)(iii)(G) contains special rules for certain intercompany transfers made by C corporation partners.

The above acceleration events only apply to deferred items allocated to direct or indirect partners of an electing partnership or to the shareholders of an electing S corporation. A direct or indirect partner's share of a related partnership's deferred OID deduction or a shareholder's share of a related S corporation's deferred OID deduction is only accelerated to the extent the deferred COD income attributable to the related partnership's or related S corporation's deferred OID deduction is taken into account by the electing entity or its owners.

I. Foreign Partners of Electing Partnership

Section 1446 and the regulations thereunder provide, in general, that if a domestic or foreign partnership has effectively connected taxable income allocable under section 704 to a foreign partner, then the partnership must withhold tax under section 1446 (section 1446 tax) at the time and in the manner prescribed in §§1.1446-1 through 1.1446-6. Section 1.1446-5 provides rules under section 1446 for tiered-partnership structures. These regulations provide a cross reference to the regulations under section 1446 to signal to partnerships, including tiered partnerships, that they may have an obligation to pay a section 1446 tax when income deferred under section 108(i) is recognized (either ratably over the inclusion period or as a result of an acceleration event).

J. Effective Date

These regulations apply to reacquisitions of applicable debt instruments in taxable years ending after December 31, 2008.

Availability of IRS documents

The IRS revenue procedure cited in this preamble is published in the Internal Revenue Bulletin and is available at: <http://www.IRS.gov>.

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. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), 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 Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Section 108(i) applies to the reacquisition of an applicable debt instrument during the brief election period, January 1, 2009 through December 31, 2010. These temporary regulations provide necessary guidance regarding the application of this new section 108(i) in order for partnerships and S corporations to timely file their tax returns. For this reason, it has been determined pursuant to 5 U.S.C. 553(b)(3)(B), that prior notice and public procedure are impracticable and contrary to the public interest. For the same reason, it has been determined pursuant to 5 U.S.C. 553(d)(3) that good cause exists for not delaying the effective date of these temporary regulations.

Drafting Information

The principal authors of these regulations are Megan A. Stoner and Joseph R. Worst of the Office of the Associate Chief Counsel (Passthroughs and Special

Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 1.108(i)-2T also issued under 26 U.S.C. 108(i)(7). * * *

Par. 2. Section 1.108(i)-2T is added to read as follows:

§1.108(i)-2T Application of section 108(i) to partnerships and S corporations (temporary).

(a) Overview. Under section 108(i), a partnership or an S corporation may elect to defer COD income arising in connection with a reacquisition of an applicable debt instrument for the deferral period. COD income deferred under section 108(i) is included in gross income ratably over the inclusion period, or earlier upon the occurrence of any acceleration event described in paragraph (b)(6) or (c)(3) of this section. If a debt instrument is issued (or treated as issued under section 108(e)(4)) in

a debt-for-debt exchange described in section 108(i)(2)(A) or a deemed debt-for-debt exchange described in §1.108(i)-3T(a), some or all of the deductions for OID with respect to such debt instrument must be deferred during the deferral period. The aggregate amount of OID deductions deferred during the deferral period is generally allowed as a deduction ratably over the inclusion period, or earlier upon the occurrence of any acceleration event described in paragraph (b)(6) or (c)(3) of this section.

Paragraph (b) of this section provides rules that apply to partnerships. Paragraph (c) of this section provides rules that apply to S corporations. Paragraph (d) of this section provides general rules that apply to partnerships and S corporations. Paragraph (e) of this section provides election procedures and reporting requirements. Paragraph (f) of this section contains the effective/applicability date. See §1.108(i)-0T(a) for definitions that apply to this section.

(b) Specific rules applicable to partnerships--(1) Allocation of COD income and partner's deferred amounts. An electing partnership that defers any portion of COD income realized from a reacquisition of an applicable debt instrument under section 108(i) must allocate all of the COD income with respect to the applicable debt instrument to its direct partners that are partners in the electing partnership immediately before the reacquisition in the manner in which the income would be included in the distributive shares of the partners under section 704 and the regulations under section 704, including §1.704-1(b)(2)(iii), without regard to section 108(i). The electing partnership may determine, in any manner, the portion, if any, of a partner's COD income amount with respect to an applicable debt instrument that is the deferred amount, and the portion, if any, that is the included amount. However, no partner's

deferred amount with respect to an applicable debt instrument may exceed that partner's COD income amount with respect to such applicable debt instrument, and the aggregate amount of the partners' COD income amounts and deferred amounts with respect to each applicable debt instrument must equal the electing partnership's COD income amount and deferred amount, respectively, with respect to each such applicable debt instrument.

(2) Basis adjustments and capital account maintenance--(i) Basis adjustments.

The adjusted basis of a partner's interest in a partnership is not increased under section 705(a)(1) by the partner's deferred amount in the taxable year of the reacquisition. The adjusted basis of a partner's interest in a partnership is not decreased under section 705(a)(2) by the partner's share of any deferred OID deduction in the taxable year in which the deferred OID accrues. The adjusted basis of a partner's interest in a partnership is adjusted under section 705(a) by the partner's share of the electing partnership's deferred items for the taxable year in which the partner takes into account such deferred items under this section.

(ii) Capital account maintenance. For purposes of maintaining a partner's capital account under §1.704-1(b)(2)(iv) and notwithstanding §1.704-1(b)(2)(iv)(n), the capital account of a partner of a partnership is adjusted under §1.704-1(b)(2)(iv) for a partner's share of an electing partnership's deferred items as if no election under section 108(i) were made.

(3) Deferred section 752 amount--(i) In general. An electing partnership shall determine, for each of its direct partners with a deferred amount, the partner's deferred section 752 amount, if any, with respect to an applicable debt instrument. A partner's

deferred section 752 amount with respect to an applicable debt instrument equals the decrease in the partner's share of a partnership liability under section 752(b) resulting from the reacquisition of the applicable debt instrument that is not treated as a current distribution of money under section 752(b) by reason of section 108(i)(6) (deferred section 752 amount). A partner's deferred section 752 amount is treated as a distribution of money by the partnership to the partner under section 752(b), at the same time and to the extent remaining in the same amount, as the partner recognizes the deferred amount with respect to the applicable debt instrument.

(ii) Electing partnership's computation of a partner's deferred section 752 amount. To compute a partner's deferred section 752 amount, the electing partnership must first determine the amount of gain that its direct partner would recognize in the taxable year of a reacquisition under section 731 as a result of the reacquisition of one or more applicable debt instruments during the taxable year absent the deferral provided in the second sentence of section 108(i)(6) (the section 108(i)(6) deferral). If a direct partner of an electing partnership would not recognize any gain under section 731 as a result of the reacquisition of one or more applicable debt instruments during the taxable year absent the section 108(i)(6) deferral, the partner will not have a deferred section 752 amount with respect to any applicable debt instrument that is reacquired during the taxable year. If a direct partner of an electing partnership would recognize gain under section 731 as a result of the reacquisition of one or more applicable debt instruments during the taxable year absent the section 108(i)(6) deferral, the partner's deferred section 752 amount for all applicable debt instruments that are reacquired during the taxable year is equal to the lesser of the partner's aggregate deferred

amounts from the electing partnership for all applicable debt instruments reacquired during the taxable year, or the gain that the partner would recognize in the taxable year of the reacquisitions under section 731 as a result of the reacquisitions absent the section 108(i)(6) deferral. In determining the amount of gain that the direct partner would recognize in the taxable year of a reacquisition under section 731 as a result of the reacquisition of one or more applicable debt instruments during the taxable year absent the section 108(i)(6) deferral, the rule under §1.731-1(a)(1)(ii) applies to any deemed distribution of money under section 752(b) resulting from a decrease in the partner's share of a reacquired applicable debt instrument that is treated as an advance or drawing of money. The amount of any deemed distribution of money under section 752(b) resulting from a decrease in the partner's share of a reacquired applicable debt instrument that is treated as an advance or drawing of money under §1.731-1(a)(1)(ii) is determined as if no COD income resulting from the reacquisition of the applicable debt instrument is deferred under section 108(i).

(iii) Multiple section 108(i) elections. If a direct partner of an electing partnership has a deferred section 752 amount under paragraph (b)(3)(ii) of this section for the taxable year of a reacquisition and the partner has a deferred amount with respect to more than one applicable debt instrument from the electing partnership for which a section 108(i) election is made in that taxable year, the partner's deferred section 752 amount with respect to each such applicable debt instrument equals the partner's deferred section 752 amount as determined under paragraph (b)(3)(ii) of this section, multiplied by a ratio, the numerator of which is the partner's deferred amount with respect to such applicable debt instrument, and the denominator of which is the

partner's aggregate deferred amounts from the electing partnership for all applicable debt instruments reacquired during the taxable year.

(iv) Electing partnership's request for information. At the request of an electing partnership, each direct partner of the electing partnership that has a deferred amount with respect to such partnership must provide to the electing partnership a written statement containing information requested by the partnership that is necessary to determine the partner's deferred section 752 amount (such as the partner's adjusted basis in the partner's interest in the electing partnership). The written statement must be signed under penalties of perjury and provided to the requesting partnership within 30 days of the date of the request by the electing partnership.

(v) Examples. The following examples illustrate the rules under paragraph (b)(3) of this section:

Example 1. (i) A and B each hold a 50 percent interest in Partnership, a calendar-year partnership. As of January 1, 2009, A and B each have an adjusted basis of \$50 in their partnership interests. Partnership has two applicable debt instruments outstanding, debt one of \$300 and debt two of \$200. On March 1, 2009, debt one is cancelled and Partnership realizes \$300 of COD income. On December 1, 2009, debt two is cancelled and Partnership realizes \$200 of COD income. The Partnership has no other income or loss items for 2009. A and B are each allocated \$150 of COD income from debt one and \$100 of COD income from debt two. Partnership makes an election under section 108(i) to defer \$225 of the \$300 of COD income realized from the reacquisition of debt one, \$150 of which is A's deferred amount, and \$75 of which is B's deferred amount. Partnership also makes an election under section 108(i) to defer \$125 of the \$200 of COD income realized from the reacquisition of debt two, \$100 of which is A's deferred amount, and \$25 of which is B's deferred amount. A has no included amount for either debt. B has an included amount of \$75 with respect to debt one and an included amount of \$75 with respect to debt two for 2009.

(ii) Under paragraph (b)(3)(ii) of this section, the amount of gain that A would recognize under section 731 as a result of the reacquisitions absent the section 108(i)(6) deferral is \$200. Thus, A's deferred section 752 amount with respect to debt one and debt two equals \$200 (the lesser of A's aggregate deferred amounts with respect to debt one and debt two of \$250, or gain that A would recognize under section

731 in 2009, as a result of the reacquisitions absent the section 108(i)(6) deferral, of \$200). Under paragraph (b)(3)(iii) of this section, \$120 of A's \$200 deferred section 752 amount relates to debt one ($\$200 \times \$150/\$250$) and \$80 relates to debt two ($\$200 \times \$100/\$250$).

(iii) Under paragraph (b)(3)(ii) of this section, the amount of gain that B would recognize under section 731 as a result of the reacquisitions absent the section 108(i)(6) deferral is \$50. Thus, B's deferred section 752 amount with respect to debt one and debt two equals \$50 (the lesser of B's aggregate deferred amounts with respect to debt one and debt two of \$100, or gain that B would recognize under section 731 in 2009, as a result of the reacquisitions absent the section 108(i)(6) deferral, of \$50). Under paragraph (b)(3)(iii) of this section, \$37.50 of B's \$50 deferred section 752 amount relates to debt one ($\$50 \times \$75/\$100$) and \$12.50 relates to debt two ($\$50 \times \$25/\$100$).

Example 2. (i) The facts are the same as in Example 1, except that Partnership has gross income for the year (including the \$500 of COD income) of \$700 and other separately stated losses of \$500. A's and B's distributive share of each item is 50 percent.

(ii) In determining the amount of gain that A would recognize under section 731 as a result of the reacquisitions absent the section 108(i)(6) deferral, Partnership first increases A's \$50 adjusted basis in his interest in Partnership by A's distributive share of Partnership income (other than the deferred amounts relating to debt one and debt two) of \$100, and then decreases A's adjusted basis in Partnership by deemed distributions under section 752(b) of \$250 and, thereafter, by A's distributive share of Partnership losses of \$250, but only to the extent that A's basis is not reduced below zero. Under paragraph (b)(3)(ii) of this section, the amount of gain that A would recognize under section 731 as a result of the reacquisitions absent section 108(i)(6) deferral is \$100. Thus, A's deferred section 752 amount with respect to debt one and debt two equals \$100 (the lesser of A's aggregate deferred amounts with respect to debt one and debt two of \$250, or gain that A would recognize under section 731 as a result of the reacquisitions absent the deferral section 108(i)(6) deferral of \$100). Under paragraph (b)(3)(iii) of this section, A's deferred section 752 amount with respect to debt one is \$60 ($\$100 \times \$150/\250), and A's deferred section 752 amount with respect to debt two is \$40 ($\$100 \times \$100/\250). A's \$250 of Partnership losses are suspended under section 704(d).

(iii) In determining the amount of gain that B would recognize under section 731 as a result of the reacquisitions absent the section 108(i)(6) deferral, Partnership first increases B's \$50 adjusted basis in his interest in Partnership by B's distributive share of Partnership income (other than the deferred amounts relating to debt one and debt two) of \$250 (\$100 other income plus \$150 included amount with respect to debt one and debt two), and then decreases B's adjusted basis in Partnership by deemed distributions under section 752(b) of \$250 and, thereafter, by B's distributive share of Partnership losses of \$250, but only to the extent that B's basis is not reduced below

zero. Under paragraph (b)(3)(ii) of this section, B would not recognize any gain under section 731 as a result of the reacquisitions absent the section 108(i)(6) deferral. Thus, B has no deferred section 752 amount with respect to either debt one or debt two. B may deduct his distributive share of Partnership losses to the extent of \$50, with the remaining \$200 suspended under section 704(d).

(4) Tiered partnerships--(i) In general. If a partnership (upper-tier partnership) is a direct or indirect partner of an electing partnership and directly or indirectly receives an allocation of a COD income amount from the electing partnership, all or a portion of which is deferred under section 108(i), the upper-tier partnership must allocate its COD income amount to its partners that are partners in the upper-tier partnership immediately before the reacquisition in the manner in which the income would be included in the distributive shares of the partners under section 704 and the regulations under section 704, including §1.704-1(b)(2)(iii), without regard to section 108(i). The upper-tier partnership may determine, in any manner, the portion, if any, of a partner's COD income amount with respect to an applicable debt instrument that is the deferred amount, and the portion, if any, that is the included amount. However, no partner's deferred amount with respect to an applicable debt instrument may exceed that partner's COD income amount with respect to such applicable debt instrument, and the aggregate amount of the partners' COD income amounts and deferred amounts with respect to each applicable debt instrument must equal the upper-tier partnership's COD income amount and deferred amount, respectively, with respect to each such applicable debt instrument.

(ii) Deferred section 752 amount. The computation of a partner's deferred section 752 amount, as described in paragraph (b)(3)(ii) of this section, is calculated only for direct partners of the electing partnership. An upper-tier partnership's deferred

section 752 amount with respect to an applicable debt instrument of the electing partnership is allocated only to those partners of the upper-tier partnership that have a deferred amount with respect to that applicable debt instrument, and in proportion to such partners' share of the upper-tier partnership's deferred amount with respect to that applicable debt instrument. A partner's share of the upper-tier partnership's deferred section 752 amount with respect to an applicable debt instrument must not exceed that partner's share of the upper-tier partnership's deferred amount with respect to the applicable debt instrument to which the deferred section 752 amount relates. The deferred section 752 amount of a partner of an upper-tier partnership is treated as a distribution of money by the upper-tier partnership to the partner under section 752(b), at the same time and to the extent remaining in the same amount, as the partner recognizes the deferred amount with respect to the applicable debt instrument.

(iii) Examples. The following examples illustrate the rules under paragraph (b)(4) of this section:

Example 1. (i) PRS, a calendar-year partnership, has two equal partners, A, an individual, and XYZ, a partnership. As of January 1, 2009, A and XYZ each have an adjusted basis of \$50 in their partnership interests. PRS has a \$500 applicable debt instrument outstanding. On June 1, 2009, the creditor agrees to cancel the \$500 indebtedness. PRS realizes \$500 of COD income as a result of the reacquisition. PRS has no other income or loss items for 2009. PRS makes an election under section 108(i) to defer \$200 of the \$500 of COD income. PRS allocates the \$500 of COD income equally between its partners (\$250 each). PRS determines that, for each partner, \$100 of the COD income amount is the deferred amount, and \$150 is the included amount. For 2009, each of A's and XYZ's share of the decrease in PRS's reacquired applicable debt instrument is \$250.

(ii) XYZ has two equal partners, individuals X and Y. X and Y share equally in XYZ's liabilities. XYZ allocates the \$250 COD income amount from PRS equally between X and Y (\$125 each). XYZ determines that X has a deferred amount of \$100 and an included amount of \$25. All \$125 of Y's COD income amount is Y's included amount. For 2009, each of X's and Y's share of XYZ's \$250 decrease in liability with respect to the reacquired applicable debt instrument of PRS is \$125.

(iii) Under paragraph (b)(3)(ii) of this section, PRS determines that XYZ has a deferred section 752 amount of \$50. Therefore, for 2009, of XYZ's \$250 share of the decrease in PRS's reacquired applicable debt instrument, \$200 is treated as a deemed distribution under section 752(b) and \$50 is the deferred section 752 amount.

(iv) Under paragraph (b)(4)(ii) of this section, none of XYZ's \$50 deferred section 752 amount is allocated to Y because Y does not have a deferred amount with respect to the reacquired applicable debt interest. XYZ's entire \$50 of deferred section 752 amount is allocated to X. Therefore, of X's \$125 share of the XYZ's decrease in liability with respect to the reacquired applicable debt instrument of PRS, \$75 is treated as a deemed distribution under section 752(b) and \$50 is X's deferred section 752 amount. Y's \$125 share of XYZ's decrease in liability with respect to the reacquired applicable debt instrument of PRS is treated as a deemed distribution under section 752(b) and none is a deferred section 752 amount.

Example 2. (i) The facts are the same as in Example 1, except for the following: XYZ has three partners, X, Y, and Z. The profits and losses of XYZ are shared 25 percent by X, 25 percent by Y, and 50 percent by Z. XYZ allocates its \$250 COD income amount from PRS \$62.50 to each of X and Y, and \$125 to Z. XYZ determines that X has a deferred amount of \$50 and an included amount of \$12.50, Y has a deferred amount of \$0 and an included amount of \$62.50, and Z has a deferred amount of \$50 and an included amount of \$75 with respect to the applicable debt instrument. X's, Y's, and Z's share of XYZ's decrease in liability with respect to the reacquired applicable debt instrument of PRS is \$62.50, \$62.50 and \$125, respectively.

(ii) Under paragraph (b)(4)(ii) of this section, none of XYZ's \$50 deferred section 752 amount is allocated to Y because Y does not have a deferred amount with respect to the reacquired applicable debt instrument. XYZ's \$50 deferred section 752 amount is allocated to X and Z in proportion to X's and Z's share of XYZ's deferred amount, or \$25 each ($\$50 \times (\$50/\$100)$). Therefore, of X's \$62.50 share of XYZ's decrease in liability with respect to the reacquired applicable debt instrument, \$37.50 is treated as a deemed distribution under section 752(b) and \$25 is X's deferred section 752 amount. All of Y's \$62.50 share of XYZ's decrease in liability with respect to the reacquired applicable debt instrument is treated as a deemed distribution under section 752(b). Of Z's \$125 share of XYZ's decrease in liability with respect to the reacquired applicable debt instrument, \$100 is treated as a deemed distribution under section 752(b) and \$25 is Z's deferred section 752 amount.

(5) S corporation partner--(i) In general. If an S corporation partner has a deferred amount with respect to an applicable debt instrument of an electing partnership, such deferred amount is shared pro rata only among those shareholders

that are shareholders of the S corporation partner immediately before the reacquisition of the applicable debt instrument.

(ii) Basis adjustments. The adjusted basis of a shareholder's stock in an S corporation partner is not increased under section 1367(a)(1) by the shareholder's share of the S corporation partner's deferred amount in the taxable year of the reacquisition. The adjusted basis of a shareholder's stock in an S corporation partner is not decreased under section 1367(a)(2) by the shareholder's share of the S corporation partner's deferred OID deduction in the taxable year in which the deferred OID accrues. The adjusted basis of a shareholder's stock in an S corporation partner is adjusted under section 1367(a) by the shareholder's share of the S corporation partner's share of the electing partnership's deferred items for the taxable year in which the shareholder takes into account its share of such deferred items under this section.

(iii) Accumulated adjustments account. The accumulated adjustments account (AAA), as defined in section 1368(e)(1), of an S corporation partner that has a deferred amount with respect to an applicable debt instrument of an electing partnership is not increased by its deferred amount in the taxable year of the reacquisition. The AAA of an S corporation partner is not decreased by its share of any deferred OID deduction in the taxable year in which the deferred OID accrues. The AAA of an S corporation partner is adjusted under section 1368(e) by a shareholder's share of the S corporation partner's share of the electing partnership's deferred items for the S period (as defined in section 1368(e)(2)) in which the shareholder of the S corporation partner takes into account its share of the deferred items under this section.

(6) Acceleration of deferred items--(i) Electing partnership-level events--

(A) General rules. Except as provided in paragraph (b)(6)(iii) of this section, a direct or indirect partner's share of an electing partnership's deferred items is accelerated and must be taken into account by such partner--

(1) In the taxable year in which the electing partnership liquidates;

(2) In the taxable year in which the electing partnership sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets;

(3) In the taxable year in which the electing partnership ceases doing business;

or

(4) In the taxable year that includes the day before the day on which the electing partnership files a petition in a Title 11 or similar case.

(B) Substantially all requirement. For purposes of this paragraph (b)(6), substantially all of a partnership's assets means assets representing at least 90 percent of the fair market value of the net assets, and at least 70 percent of the fair market value of the gross assets, held by the partnership immediately prior to the sale, exchange, transfer, or gift. For purposes of applying the rule in paragraph (b)(6)(i)(A)(2) of this section, a sale, exchange, transfer, or gift by any direct or indirect lower-tier partnership of the electing partnership (lower-tier partnership) of all or part of its assets is not treated as a sale, exchange, transfer, or gift of the assets of any partnership that holds, directly or indirectly, an interest in such lower-tier partnership. However, for purposes of applying the rule in paragraph (b)(6)(i)(A)(2) of this section, a sale, exchange, transfer, or gift of substantially all of the assets of a transferee partnership (as described in paragraph (b)(6)(iii)(A)(1) of this section), or of a lower-tier partnership that received

assets of the electing partnership from a transferee partnership or another lower-tier partnership in a transaction governed all or in part by section 721, is treated as a sale, exchange, transfer, or gift by the holder of an interest in such transferee partnership or lower-tier partnership of its entire interest in that transferee partnership or lower-tier partnership.

(ii) Direct or indirect partner-level events--(A) General rules. Except as provided in paragraph (b)(6)(iii) of this section, a direct or indirect partner's share of an electing partnership's deferred items with respect to a separate interest is accelerated and must be taken into account by such partner in the taxable year in which--

(1) The partner dies or liquidates;

(2) The partner sells, exchanges (including redemptions treated as exchanges under section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under section 1041) all or a portion of its separate interest;

(3) The partner's separate interest is redeemed within the meaning of paragraph (b)(6)(ii)(B)(2) of this section; or

(4) The partner abandons its separate interest.

(B) Meaning of terms; special rules--(1) Partial transfers. For purposes of paragraph (b)(6)(ii)(A)(2) of this section, if a partner sells, exchanges (including redemptions treated as exchanges under section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under section 1041) a portion of its separate interest, such partner's share of the electing partnership's deferred items with respect to the separate interest proportionate to the separate

interest sold, exchanged, transferred, or gifted is accelerated and must be taken into account by such partner.

(2) Redemptions. For purposes of paragraph (b)(6)(ii)(A)(3) of this section, a partner's separate interest is redeemed if the partner receives a distribution of cash and/or property in complete liquidation of such separate interest.

(3) S corporation partners. In addition to the rules in paragraphs (b)(6)(i) and (ii) of this section, an S corporation partner's share of the electing partnership's deferred items is accelerated and the shareholders of the S corporation partner must take into account their respective shares of the S corporation partner's share of the electing partnership's deferred items in the taxable year in which the S corporation partner's election under section 1362(a) terminates.

(4) C corporation partners. In addition to the rules in paragraphs (b)(6)(i), (ii), and (iii) of this section, the acceleration rules in §1.108(i)-1T(b) and the earnings and profits rules in §1.108(i)-1T(d) apply to partners that are electing corporations.

(iii) Events not constituting acceleration. Notwithstanding the rules in paragraphs (b)(6)(i) and (ii) of this section, a direct or indirect partner's share of an electing partnership's deferred items with respect to a separate interest is not accelerated by any of the events described in this paragraph (b)(6)(iii).

(A) Section 721 contributions--(1) Electing partnership contributions. A direct or indirect partner's share of an electing partnership's deferred items is not accelerated if the electing partnership contributes all or a portion of its assets in a transaction governed all or in part by section 721(a) to another partnership (transferee partnership) in exchange for an interest in the transferee partnership provided that the electing

partnership does not terminate under section 708(b)(1)(A) or transfer its assets and liabilities in a transaction described in section 708(b)(2)(A) or section 708(b)(2)(B). See paragraph (b)(6)(iii)(D) of this section for transactions governed by section 708(b)(2)(A). Notwithstanding the rules in this paragraph (b)(6)(iii)(A)(1), the rules in paragraphs (b)(6)(i)(A) and (b)(6)(ii)(A) of this section apply to any part of the transaction to which section 721(a) does not apply.

(2) Partner contributions. A direct or indirect partner's share of an electing partnership's deferred items with respect to a separate interest is not accelerated if the holder of such interest (contributing partner) contributes its entire separate interest (contributed separate interest) in a transaction governed all or in part by section 721(a) to another partnership (transferee partnership) in exchange for an interest in the transferee partnership provided that the partnership in which the separate interest is held does not terminate under section 708(b)(1)(A) or transfer its assets and liabilities in a transaction described in section 708(b)(2)(A) or section 708(b)(2)(B). See paragraph (b)(6)(iii)(D) of this section for transactions governed by section 708(b)(2)(A). The transferee partnership becomes subject to section 108(i), including all reporting requirements under this section, with respect to the contributing partner's share of the electing partnership's deferred items associated with the contributed separate interest. The transferee partnership must allocate and report the share of the electing partnership's deferred items that is associated with the contributed separate interest to the contributing partner to the same extent that such share of the electing partnership's deferred items would have been allocated and reported to the contributing partner in the absence of such contribution. Notwithstanding the rules in this paragraph

(b)(6)(iii)(A)(2), the rules in paragraph (b)(6)(ii)(A) of this section apply to any part of the transaction to which section 721(a) does not apply.

(B) Section 1031 exchanges. A direct or indirect partner's share of the electing partnership's deferred items is not accelerated if the electing partnership transfers property held for productive use in a trade or business or for investment in exchange for property of like kind which is to be held either for productive use in a trade or business or for investment in a transaction to which section 1031(a)(1) applies. Notwithstanding the rules in this paragraph (b)(6)(iii)(B), to the extent the electing partnership receives money or other property which does not meet the requirements of section 1031(a) (boot) in the exchange, a proportionate amount of the property transferred by the electing partnership equal to the proportion of the boot to the total consideration received in the exchange shall be treated as sold for purposes of paragraph (b)(6)(i)(A)(2) of this section.

(C) Section 708(b)(1)(B) terminations. A direct or indirect partner's share of the deferred items of an electing partnership with respect to a separate interest is not accelerated if the electing partnership or a partnership that is a direct or indirect partner of the electing partnership terminates under section 708(b)(1)(B). Notwithstanding the rules in this paragraph (b)(6)(iii)(C), the rules in paragraph (b)(6)(ii)(A) of this section apply to the event that causes the termination under section 708(b)(1)(B) to the extent not otherwise excepted under paragraph (b)(6)(iii) of this section.

(D) Section 708(b)(2)(A) mergers or consolidations. A direct or indirect partner's share of the deferred items of an electing partnership with respect to a separate interest is not accelerated if the partnership in which the separate interest is held (the merger

transaction partnership) merges into or consolidates with another partnership in a transaction to which section 708(b)(2)(A) applies. The resulting partnership or new partnership, as determined under §1.708-1(c)(1), becomes subject to section 108(i), including all reporting requirements under this section, to the same extent that the merger transaction partnership was so subject prior to the transaction, and must allocate and report any merger transaction partnership's deferred items to the same extent and to the same partners that the merger transaction partnership allocated and reported such items prior to such transaction. Notwithstanding the rules in this paragraph (b)(6)(iii)(D), the rules in paragraphs (b)(6)(i)(A)(2) and (b)(6)(ii)(A)(2) of this section apply to that portion of the transaction that is treated as a sale, and the rules of (b)(6)(ii)(A)(3) apply if, as part of the transaction, the partner's separate interest is redeemed and the partner does not receive an interest in the resulting partnership with respect to such separate interest.

(E) Certain distributions of separate interests. If a partnership (upper-tier partnership) that is a direct or indirect partner of an electing partnership distributes its entire separate interest (distributed separate interest) to one or more of its partners (distributee partners) that have a share of the electing partnership's deferred items from upper-tier partnership with respect to the distributed separate interest, the distributee partners' shares of the electing partnership's deferred items with respect to such distributed separate interest are not accelerated. The partnership, the interest in which was distributed, must allocate and report the share of the electing partnership's deferred items associated with the distributed separate interest only to such distributee partners

that had a share of the electing partnership's deferred items from the upper-tier partnership with respect to the distributed separate interest prior to the distribution.

(F) Section 381 transactions. A C corporation partner's share of an electing partnership's deferred items is not accelerated if, as part of a transaction described in paragraph (b)(6)(ii)(A) of this section, the assets of the C corporation partner are acquired by another C corporation (acquiring C corporation) in a transaction that is treated, under §1.108(i)-1T(b)(2)(ii)(B), as a transaction to which section 381(a) applies. An S corporation partner's share of an electing partnership's deferred items is not accelerated if, as part of a transaction described in paragraph (b)(6)(ii)(A) of this section, the assets of the S corporation partner are acquired by another S corporation (acquiring S corporation) in a transaction to which section 381(a) applies. In such cases, the acquiring C corporation or acquiring S corporation, as the case may be, succeeds to the C corporation partner's or the S corporation partner's remaining share of the electing partnership's deferred items and becomes subject to section 108(i), including all reporting requirements under this section, as if the acquiring C corporation or acquiring S corporation were the C corporation partner or the S corporation partner, respectively. The acquiring S corporation must allocate and report the S corporation partner's deferred items to the same extent and only to those shareholders of the S corporation partner who had a share of the S corporation partner's deferred items from the electing partnership prior to the transaction.

(G) Intercompany transfers. A C corporation partner's share of an electing partnership's deferred items is not accelerated if, as part of a transaction described in paragraph (b)(6)(ii)(A) of this section, the C corporation partner transfers its entire

separate interest in an intercompany transaction, as described in §1.1502-13(b)(1)(i), and the electing partnership does not terminate under section 708(b)(1)(A) as a result of the intercompany transaction.

(H) Retirement of a debt instrument. See §1.108(i)-3T(c)(1) for rules regarding the retirement of a debt instrument that is subject to section 108(i).

(I) Other non-acceleration events. A direct or indirect partner's share of an electing partnership's deferred items is not accelerated with respect to any transaction if the Commissioner makes a determination by published guidance that such transaction is not an acceleration event under the rules of this paragraph (b)(6).

(iv) Related partnerships. A direct or indirect partner's share of a related partnership's deferred OID deduction (as determined in paragraph (d)(2) of this section) that has not previously been taken into account is accelerated and taken into account by the direct or indirect partner in the taxable year in which, and to the extent that, deferred COD income attributable to the related partnership's deferred OID deduction is taken into account by the electing entity or its owners.

(v) Examples. The following examples illustrate the rules under this paragraph (b)(6):

Example 1. Meaning of "separate interest." (i) Electing partnership (EP) has three partners, MT1, MT2, and UT, each of which is a partnership. The partners of MT1 are X and UT. The partners of MT2 are Y, UT, and B. The partners of UT are A, B, and C. In addition to their interests in the partnerships noted, MT1, MT2, and UT own other assets.

(ii) Within the meaning of paragraph (a)(29) of §1.108(i)-0T, A and C each hold one separate interest (their interests in UT), B holds two separate interests (its interests in UT and MT2), UT holds three separate interests (its interests in MT1, MT2, and EP), MT1 and MT2 each hold one separate interest (their interests in EP), and X and Y each hold one separate interest (their interests in MT1 and MT2, respectively) with respect to EP.

Example 2. Distributions of separate interests in an electing partnership. (i) The facts are the same as in Example 1, except that A, as a direct partner of UT, has a share of EP's deferred items with respect to UT's interests in MT1 and EP. A does not have a share of EP's deferred items with respect to UT's interest in MT2. B, as a direct partner of UT, has a share of EP's deferred items with respect to UT's interest in MT1 and MT2, but not with respect to UT's interest in EP. B also has a share of EP's deferred items with respect to its separate interest in MT2. C does not have any share of EP's deferred items with respect to UT's interest in MT1, MT2, or EP.

(ii) UT distributes 40 percent of its separate interest in MT1 to A in redemption of A's interest in UT. Under paragraphs (b)(6)(ii)(A)(2) and (b)(6)(ii)(B)(1) of this section, a portion of UT's interest in MT1 has been transferred and a corresponding portion (40 percent) of UT's share of EP's deferred items from MT1 is accelerated. Thus, 40 percent of A's and B's share of EP's deferred items from UT with respect to UT's interest in MT1 is accelerated. Further, because A's interest in UT is redeemed within the meaning of paragraph (b)(6)(ii)(B)(2) of this section, all of A's shares of EP's deferred items from UT are accelerated under paragraph (b)(6)(ii)(A)(3) of this section. UT continues to allocate and report to B its remaining share of EP's deferred items from its separate interest in MT1 that was not distributed to A.

(iii) UT distributes its entire separate interest in MT1 to B (other than in redemption of B's interest in UT). Under paragraph (b)(6)(ii)(A)(2) of this section, UT's share of EP's deferred items from MT1 would be accelerated. However, because UT distributes its entire separate interest in MT1 to B, B's share of EP's deferred items from UT with respect to UT's separate interest in MT1 is not accelerated under paragraph (b)(6)(iii)(E) of this section. MT1 allocates and reports to B B's share of EP's deferred items from UT's separate interest in MT1 that was distributed to B.

(iv) UT distributes its entire separate interest in MT1 to A and B (other than in redemption of their interests in UT). Under paragraph (b)(6)(iii)(E) of this section, none of A's or B's shares of EP's deferred items from UT with respect to UT's separate interest in MT1 is accelerated, and MT1 allocates and reports to A and B their respective share of EP's deferred items from UT's separate interest in MT1 that was distributed to A and B.

Example 3. Partial sale of interest by an indirect partner. (i) Individual A holds a 50 percent partnership interest in UTP, a partnership that holds a 50 percent interest in EP, a partnership that makes an election to defer COD income under section 108(i). A's share of UTP's deferred amount with respect to EP's election under section 108(i) is \$100. During a taxable year within the deferral period, A sells 25 percent of his partnership interest in UTP to an unrelated third party.

(ii) Under paragraphs (b)(6)(ii)(A)(2) and (b)(6)(ii)(B)(1) of this section, 25 percent of A's \$100 deferred amount is accelerated as a result of A's partial sale of his interest

in UTP. Thus, A must recognize \$25 of his deferred amount in the taxable year of the sale. A's remaining deferred amount is \$75.

Example 4. Section 708(b)(1)(B) termination of electing partnership. (i) A and B are equal partners in partnership AB. On January 1, 2009, AB reacquires an applicable debt instrument and makes an election under section 108(i) to defer \$400 of COD income. A and B each have a deferred amount with respect to the applicable debt instrument of \$200. On January 1, 2010, A sells its entire 50 percent interest in AB to C in a transfer that terminates the partnership under section 708(b)(1)(B).

(ii) Under paragraph (b)(6)(iii)(C) of this section, the technical termination of AB under section 708(b)(1)(B) does not cause A's or B's shares of AB's deferred items to be accelerated. However, A's \$200 deferred amount is accelerated under paragraph (b)(6)(ii)(A)(2) of this section as a result of the sale.

Example 5. Section 708(b)(2)(A) mergers. (i) A, B, and C are equal partners in partnership X, which has made an election under section 108(i) to defer \$150 of COD income. The fair market value of each interest in partnership X is \$100. A, B, and C each has a deferred amount of \$50 with respect to partnership X's election under section 108(i). E, F, and G are partners in partnership Y. Partnership X and partnership Y merge in a taxable year during the deferral period of partnership X's election under section 108(i). Under section 708(b)(2)(A), the resulting partnership is considered a continuation of partnership Y and partnership X is considered terminated. Under state law, partnerships X and Y undertake the assets-over form of §1.708-1(c)(3)(i) to accomplish the merger. C does not want to become a partner in partnership Y, and partnership X does not have the resources to redeem C's interest before the merger. C, partnership X, and partnership Y enter into a merger agreement that satisfies the requirements of §1.708-1(c)(4) and specifies that partnership Y will purchase C's interest in partnership X for \$100 before the merger, and as part of the agreement, C consents to treat the transaction in a manner that is consistent with the agreement. As part of the merger, partnership X receives from partnership Y \$100 (which will be distributed to C immediately before the merger), \$100 (which will be distributed equally to A and B (\$50 each)), and interests in partnership Y with a value of \$100 (which will be distributed equally to A and B) in exchange for partnership X's assets and liabilities.

(ii) Under the general rule of paragraph (b)(6)(iii)(D) of this section, and except as provided below, the deferred items of partnership X are not accelerated as a result of the merger with partnership Y. Partnership Y, the resulting partnership that is considered the continuation of partnership X, becomes subject to section 108(i), including all reporting requirements under section 108(i), to the same extent that partnership X was subject to such rules. Under paragraph (b)(6)(iii)(D) of this section, partnership Y must allocate and report partnership X's deferred items to A and B in the same manner as partnership X had prior to the merger transaction.

(iii) Under §1.708-1(c)(4), C is treated as selling its interest in partnership X immediately before the merger. As a result, C's \$50 deferred amount is accelerated under paragraph (b)(6)(ii)(A)(2) of this section.

(iv) Under section 707(a)(2)(B), partnership X is deemed to have sold a portion of its assets to partnership Y. Because partnership X is not treated as selling substantially all of its assets under paragraph (b)(6)(i)(B) of this section, A's and B's deferred amounts are not accelerated under paragraph (b)(6)(i)(A)(2) of this section.

(v) Because A's and B's interests in partnership X are redeemed within the meaning of paragraph (b)(6)(ii)(B)(2) of this section, all of their shares of partnership X's deferred items would be accelerated under paragraph (b)(6)(ii)(A)(3). However, because they receive an interest in partnership Y in the merger, none of A's and B's share of partnership X's deferred items is accelerated.

(7) Withholding under section 1446. See section 1446 regarding withholding by a partnership on a foreign partner's share of income effectively connected with a U.S. trade or business.

(c) Specific rules applicable to S corporations--(1) Deferred COD income. An electing S corporation's COD income deferred under section 108(i) (an S corporation's deferred COD income) is shared pro rata among those shareholders that are shareholders of the electing S corporation immediately before the reacquisition of the applicable debt instrument. Any COD income deferred under section 108(i) is taken into account under section 1366(a) by those shareholders in the inclusion period, or earlier upon the occurrence of an acceleration event described in paragraph (c)(3) of this section.

(2) Basis adjustments and accumulated adjustments account--(i) Basis adjustments. The adjusted basis of a shareholder's stock in an electing S corporation is not increased under section 1367(a)(1) by the shareholder's share of the S corporation's deferred COD income in the taxable year of the reacquisition. The adjusted basis of a shareholder's stock in an electing S corporation or a related

S corporation is not decreased under section 1367(a)(2) by the shareholder's share of the S corporation's deferred OID deduction in the taxable year in which the deferred OID accrues. The adjusted basis of a shareholder's stock in an electing S corporation or a related S corporation is adjusted under section 1367(a) by the shareholder's share of the S corporation's deferred items for the taxable year in which the shareholder takes into account its share of the deferred items under this section.

(ii) Accumulated adjustments account. The AAA of an electing S corporation is not increased by the S corporation's deferred COD income in the taxable year of a reacquisition. The AAA of an electing S corporation or a related S corporation is not decreased by the S corporation's deferred OID deduction in the taxable year in which the deferred OID accrues. The AAA of an electing S corporation or a related S corporation is adjusted under section 1368(e) by a shareholder's share of the S corporation's deferred items for the S period (as defined in section 1368(e)(2)) in which a shareholder of the S corporation takes into account its share of the deferred items under this section.

(3) Acceleration of deferred items--(i) Electing S corporation-level events--(A) General rules. Except as provided in paragraph (c)(3)(iii) of this section, a shareholder's share of an electing S corporation's deferred items is accelerated and must be taken into account by such shareholder--

(1) In the taxable year in which the electing S corporation liquidates;

(2) In the taxable year in which the electing S corporation sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets;

(3) In the taxable year in which the electing S corporation ceases doing business;

(4) In the taxable year in which the electing S corporation's election under section 1362(a) terminates; or

(5) In the taxable year that includes the day before the day on which the electing S corporation files a petition in a Title 11 or similar case.

(B) Substantially all requirement. For purposes of this paragraph (c)(3), substantially all of an electing S corporation's or partnership's assets means assets representing at least 90 percent of the fair market value of the net assets, and at least 70 percent of the fair market value of the gross assets, held by the S corporation or partnership immediately prior to the sale, exchange, transfer, or gift. For purposes of applying the rule in paragraph (c)(3)(i)(A)(2) of this section, a sale, exchange, transfer, or gift by any direct or indirect lower-tier partnership of the electing S corporation (lower-tier partnership) of all or part of its assets is not treated as a sale, exchange, transfer, or gift of the assets of any person that holds, directly or indirectly, an interest in such lower-tier partnership. However, for purposes of applying the rule in paragraph (c)(3)(i)(A)(2) of this section, a sale, exchange, transfer, or gift of substantially all of the assets of a transferee partnership (as described in paragraph (c)(3)(iii)(A) of this section), or of a lower-tier partnership that received assets of the electing S corporation from a transferee partnership of the electing S corporation or another lower-tier partnership in a transaction governed all or in part by section 721, is treated as a sale, exchange, transfer, or gift by the holder of an interest in such transferee partnership or lower-tier partnership of its entire interest in that transferee partnership or lower-tier partnership.

(ii) Shareholder events--(A) General rules. Except as provided in paragraph (c)(3)(iii) of this section, a shareholder's share of an electing S corporation's deferred items is accelerated and must be taken into account by such shareholder in the taxable year in which--

(1) The shareholder dies;

(2) The shareholder sells, exchanges (including redemptions treated as exchanges under section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under section 1041) all or a portion of its interest in the electing S corporation; or

(3) The shareholder abandons its interest in the electing S corporation.

(B) Partial transfers. For purposes of paragraph (c)(3)(ii)(A)(2) of this section, if a shareholder of an electing S corporation sells, exchanges (including redemptions treated as exchanges under section 302), transfers, or gifts (including transfers treated as gifts under section 1041) a portion of its interest in the electing S corporation, such shareholder's share of the electing S corporation's deferred items proportionate to the interest that was sold, exchanged, transferred, or gifted is accelerated and must be taken into account by such shareholder.

(iii) Events not constituting acceleration. Notwithstanding the rules in paragraphs (c)(3)(i) and (ii) of this section, a shareholder's share of an electing S corporation's deferred items is not accelerated by any of the events described in this paragraph (c)(3)(iii).

(A) Electing S corporation's contributions. A shareholder's share of an electing S corporation's deferred items is not accelerated if the electing S corporation

contributes all or a portion of its assets in a transaction governed all or in part by section 721(a) to a partnership (transferee partnership) in exchange for an interest in the transferee partnership. Notwithstanding the rules in this paragraph (c)(3)(iii)(A), the rules in paragraph (c)(3)(i)(A) of this section apply to any part of the transaction to which section 721(a) does not apply.

(B) Section 1031 exchanges. A shareholder's share of an electing S corporation's deferred items is not accelerated if the electing S corporation transfers property held for productive use in a trade or business or for investment in exchange for property of like kind which is to be held either for productive use in a trade or business or for investment in a transaction to which section 1031(a)(1) applies. Notwithstanding the rules in this paragraph (c)(3)(iii)(B), to the extent the electing S corporation receives money or other property which does not meet the requirements of section 1031(a) (boot) in the exchange, a proportionate amount of the property transferred by the electing S corporation equal to the proportion of the boot to the total consideration received in the exchange shall be treated as sold for purposes of paragraph (c)(3)(i)(A)(2) of this section.

(C) Section 381 transactions. A shareholder's share of an electing S corporation's deferred items is not accelerated if, as part of a transaction described in paragraph (c)(3)(i)(A) of this section, the electing S corporation's assets are acquired by another S corporation (acquiring S corporation) in a transaction to which section 381(a) applies. In such a case, the acquiring S corporation succeeds to the electing S corporation's remaining deferred items and becomes subject to section 108(i), including all reporting requirements under this section, as if the acquiring S corporation

were the electing S corporation. The acquiring S corporation must allocate and report the electing S corporation's deferred items to the same extent and only to those shareholders who had a share of the electing S corporation's deferred items prior to the transaction.

(D) Retirement of a debt instrument. See §1.108(i)-3T(c)(1) for rules regarding the retirement of a debt instrument that is subject to section 108(i).

(E) Other non-acceleration events. A shareholder's share of an electing S corporation's deferred items is not accelerated with respect to any transaction if the Commissioner makes a determination by published guidance that such transaction is not an acceleration event under the rules of this paragraph (c)(3).

(iv) Related S corporations. A shareholder's share of a related S corporation's deferred OID deduction (as determined in paragraph (d)(2) of this section) that has not previously been taken into account is accelerated and taken into account by the shareholder in the taxable year in which, and to the extent that, deferred COD income attributable to the related S corporation's deferred OID deduction is taken into account by the electing entity or its owners.

(d) General rules applicable to partnerships and S corporations--(1) Applicable debt instrument (trade or business requirement). The determination of whether a debt instrument issued by a partnership or an S corporation is treated as a debt instrument issued in connection with the conduct of a trade or business by the partnership or S corporation for purposes of this section is based on all the facts and circumstances. However, a debt instrument issued by a partnership or an S corporation shall be treated

as an applicable debt instrument for purposes of this section if the electing partnership or electing S corporation can establish that--

(i) The gross fair market value of the trade or business assets of the partnership or S corporation that issued the debt instrument represented at least 80 percent of the gross fair market value of that partnership's or S corporation's total assets on the date of issuance;

(ii) The trade or business expenditures of the partnership or S corporation that issued the debt instrument represented at least 80 percent of the partnership's or S corporation's total expenditures for the taxable year of issuance;

(iii) At least 95 percent of interest paid or accrued on the debt instrument issued by the partnership or S corporation was allocated to one or more trade or business expenditures under §1.163-8T for the taxable year of issuance;

(iv) At least 95 percent of the proceeds from the debt instrument issued by the partnership or S corporation were used by the partnership or S corporation to acquire one or more trades or businesses within six months from the date of issuance; or

(v) The partnership or S corporation issued the debt instrument to a seller of a trade or business to acquire the trade or business.

(2) Deferral of OID at entity level--(i) In general. For each taxable year during the deferral period, an issuing entity determines the amount of its deferred OID deduction with respect to a debt instrument, if any. An issuing entity's deferred OID deduction for a taxable year is the lesser of:

(A) The OID that accrues in a current taxable year during the deferral period with respect to the debt instrument (less any of such OID that is allowed as a deduction in the current taxable year as a result of an acceleration event), or

(B) The excess, if any, of the electing entity's deferred COD income (less the aggregate amount of such deferred COD income that has been included in income in the current taxable year and any previous taxable year during the deferral period) over the aggregate amount of OID that accrued in previous taxable years during the deferral period with respect to the debt instrument (less the aggregate amount of such OID that has been allowed as a deduction in the current taxable year and any previous taxable year during the deferral period).

(ii) Excess deferred OID deduction. If, as a result of an acceleration event during a taxable year in the deferral period, an issuing entity's aggregate deferred OID deduction for previous taxable years with respect to a debt instrument (less the aggregate amount of such deferred OID deduction that has been allowed as a deduction in a previous taxable year during the deferral period) exceeds the amount of the electing entity's deferred COD income (less the aggregate amount of such deferred COD income that has been included in income in the current taxable year and any previous taxable year during the deferral period), the excess deferred OID deduction shall be allowed as a deduction in the taxable year in which the acceleration event occurs.

(iii) Examples. The following examples illustrate the rules under paragraph (d)(2) of this section:

Example 1. Partner joins partnership during deferral period. (i) A and B each hold a 50 percent interest in AB partnership, a calendar-year partnership. On

January 1, 2009, AB partnership issues a new debt instrument with OID and uses all of the proceeds to reacquire an outstanding applicable debt instrument of AB partnership, realizing \$100 of COD income, and makes an election under section 108(i) to defer \$50 of the COD income. During the deferral period, a total of \$150 of OID accrues on the new debt instrument issued as part of the reacquisition. A and B each have a deferred amount of \$25 with respect to the applicable debt instrument reacquired by AB partnership. For 2009, \$28 of OID accrues on the new debt instrument and A and B are each allocated \$14 of accrued OID with respect to the new debt instrument. On January 1, 2010, C contributes cash to AB partnership in exchange for a 1/3 partnership interest. For 2010, \$29 of OID accrues on the new debt instrument, and A, B, and C are each allocated \$9.67 of accrued OID.

(ii) Under paragraph (d)(2) of this section, AB partnership's deferred OID deduction for 2009 is the lesser of: \$28 of OID that accrues on the new debt instrument in 2009, or the excess of AB partnership's deferred COD income of \$50 over the aggregate amount of OID that accrued on the debt instrument in previous taxable years during the deferral period of \$0, or \$50. Thus, all \$28 of the OID that accrues on the debt instrument in 2009 is deferred under section 108(i).

(iii) Under paragraph (d)(2) of this section, AB partnership's deferred OID deduction for 2010 is the lesser of: \$29 of OID that accrues on the new debt instrument in 2010, or the excess of AB partnership's deferred COD income of \$50 over the aggregate amount of OID that accrued on the debt instrument in previous taxable years during the deferral period of \$28, or \$22. Thus, \$22 of the \$29 of OID that accrues in 2010 is deferred under section 108(i). A, B, and C will each defer \$7.33 of the \$9.67 of accrued OID that was allocated to each of them.

Example 2. Acceleration of deferred items during deferral period. (i) On January 1, 2009, ABC partnership, a calendar-year partnership with three partners, issues a new debt instrument with OID and uses all of the proceeds to reacquire an outstanding applicable debt instrument of ABC partnership. ABC partnership realizes \$150 of COD income and makes an election under section 108(i) to defer the \$150 of COD income. A's deferred amount with respect to the applicable debt instrument is \$75, while B and C each have a deferred amount of \$37.50. In 2009, \$28 of OID accrues on the new debt instrument and is allocated \$7.00 to A and \$10.50 to each of B and C. In 2010, \$29 of OID accrues on the new debt instrument and is allocated \$7.25 to A and \$10.87 to each of B and C. In 2011, \$30 of OID accrues on the new debt instrument and is allocated \$7.50 to A and \$11.25 to each of B and C. In 2012, \$31 of OID accrues on the new debt instrument and is allocated \$7.75 to A and \$11.62 to each of B and C. On December 31, 2012, A's entire share of ABC partnership's deferred items is accelerated under paragraph (b)(6) of this section. For 2012, A includes \$75 of COD income in income and is allowed a deduction of \$21.75 for A's share of ABC partnership's deferred OID deduction for taxable years 2009 through 2011, and a deduction of \$7.75 for A's share of ABC partnership's OID that accrues on the debt instrument in 2012.

(ii) Under paragraph (d)(2) of this section, ABC partnership's deferred OID deduction for 2012 is the lesser of: \$23.35 (\$31 of OID that accrues on the new debt instrument in 2012 less \$7.75 of this OID that is allowed as a deduction to A in 2012) or \$9.75 (the excess of \$75 (ABC partnership's deferred COD income of \$150 less A's share of ABC partnership's deferred COD income that is included in A's income for 2012 of \$75) over \$65.25 (the aggregate amount of OID that accrued in previous taxable years of \$87 less the aggregate amount of such OID that has been allowed as a deduction by A in 2012 of \$21.75)). Thus, of the \$31 of OID that accrues in 2012, \$9.75 is deferred under section 108(i).

(3) Effect of an election under section 108(i) on recapture amounts under section 465(e)--(i) In general. To the extent that a decrease in a partner's or shareholder's amount at risk (as defined in section 465) in an activity as a result of a reacquisition of an applicable debt instrument would cause a partner with a deferred amount or a shareholder with a share of the S corporation's deferred COD income to have income under section 465(e) in the taxable year of the reacquisition, such decrease (not to exceed the partner's deferred amount or the shareholder's share of the S corporation's deferred COD income with respect to that applicable debt instrument) (deferred section 465 amount) shall not be taken into account for purposes of determining the partner's or shareholder's amount at risk in an activity under section 465 as of the close of the taxable year of the reacquisition. A partner's or shareholder's deferred section 465 amount is treated as a decrease in the partner's or shareholder's amount at risk in an activity at the same time, and to the extent remaining in same amount, as the partner recognizes its deferred amount or the S corporation shareholder recognizes its share of the S corporation's deferred COD income.

(ii) Example. The following example illustrates the rules in paragraph (d)(3) of this section:

Example. (i) PRS is a calendar-year partnership with two equal partners, individuals A and B. PRS is engaged in an activity described in section 465(c) (Activity).

PRS has a \$500 recourse applicable debt instrument outstanding. Each partner's amount at risk on January 1, 2009 is \$50. On June 1, 2009, the creditor agrees to cancel the \$500 indebtedness. PRS realizes \$500 of COD income as a result of the reacquisition. The partners' share of the liabilities of PRS decreases by \$500 under section 752(b), and each partner's amount at risk is decreased by \$250. Other than the \$500 of COD income, PRS's income and expenses for 2009 are equal. PRS makes an election under section 108(i) to defer \$200 of the \$500 COD income realized in connection with the reacquisition. PRS allocates the \$500 of COD income equally between its partners, A and B. A and B each have a COD income amount of \$250 with respect to the applicable debt instrument. PRS determines that, for both partners A and B, \$100 of the \$250 COD income amount is the deferred amount, and \$150 is the included amount. Beginning in each taxable year 2014 through 2018, A and B each include \$20 of the deferred amount in gross income.

(ii) Under paragraph (d)(3)(i) of this section, \$50 of the \$250 decrease in A's and B's amount at risk in Activity is the deferred section 465 amount for each of A and B and is not taken into account for purposes of determining A's and B's amount at risk in Activity at the close of 2009. In taxable year 2014, A's and B's amount at risk in Activity is decreased by \$20 (deferred section 465 amount that equals the deferred amount included in A's and B's gross income in 2014). In taxable year 2015, A's and B's amount at risk in Activity is decreased by \$20 for the deferred section 465 amount that equals the deferred amount included in A's and B's gross income in 2015. In taxable year 2016, A's and B's amount at risk in Activity is decreased by \$10 (the remaining amount of the deferred section 465 amount).

(e) Election procedures and reporting requirements--(1) Partnerships--(i) In general. A partnership makes an election under section 108(i) by following procedures outlined in guidance and applicable forms and instructions issued by the Commissioner. An electing partnership (or its successor) must provide to its partners certain information as required by guidance and applicable forms and instructions issued by the Commissioner.

(ii) Tiered pass-through entities. A partnership that is a direct or indirect partner of an electing partnership (or its successor) or a related partnership or an S corporation partner must provide to its partners or shareholders, as the case may be, certain information as required by guidance and applicable forms and instructions issued by the Commissioner.

(iii) Related partnerships. A related partnership must provide to its partners certain information as required by guidance and applicable forms and instructions issued by the Commissioner.

(2) S corporations--(i) In general. An S corporation makes an election under section 108(i) by following procedures outlined in guidance and applicable forms and instructions issued by the Commissioner. An electing S corporation (or its successor) must provide to its shareholders certain information as required by guidance and applicable forms and instructions issued by the Commissioner.

(ii) Related S corporations. A related S corporation must provide to its shareholders certain information as required by guidance and applicable forms and instructions issued by the Commissioner.

(f) Effective/applicability date. For the applicability dates of this section, see §1.108(i)-0T(b).

(g) Expiration date. This section expires on August 9, 2013.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION
ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.108(i)-2T	1545-2147
* * * * *	

Steven T. Miller
Deputy Commissioner for Services and Enforcement.

Approved: August 6, 2010

Michael F. Mundaca
Assistant Secretary of the Treasury (Tax Policy).

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