because of the basis limitation in section 1366(d)(1) and which are treated as incurred by the corporation with respect to *A* in the following taxable year. Halfway through the 2007 taxable year, *A* transfers 50 shares to *B*, *A*'s former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, *X* has $80 in losses. On *A*'s 2007 individual income tax return, *A* may use the entire $100 carryover loss from 2006, as well as *A*'s share of the $80 2007 loss determined under section 1377(a) ($60), assuming *A* acquires sufficient basis in the *X* stock. On *B*'s 2007 individual income tax return, *B* may use *B*'s share of the $80 2007 loss determined under section 1377(a) ($20), assuming *B* has sufficient basis in the *X* stock. If any disallowed 2006 loss is disallowed to *A* under section 1366(d)(1) in 2007, that loss is prorated between *A* and *B* based on their stock ownership at the beginning of 2008. On *B*'s 2008 individual income tax return, *B* may use that loss, assuming *B* acquires sufficient basis in the *X* stock. If neither *A* nor *B* acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to *A* and $50 of loss with respect to *B* for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to *A* and $20 with respect to *B* for the $80 of disallowed 2007 loss.

Example 2. Assume the same facts as *Example 1,* except that during the 2007 taxable year, *A* acquires $10 of basis in *A*'s shares in *X*. For the 2007 taxable year, *A* may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of *A*'s 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to *A* and half of that loss with respect to *B* for the remaining $93.75 of disallowed 2006 loss, and if *B* does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to *A* and $20 with respect to *B* for the remaining disallowed 2007 loss.

* * * * *

Par. 10. Section 1.1366–5 is amended by adding a new sentence at the end.

The addition reads as follows:

§ 1.1366–5 Effective/applicability date.

* * * Paragraphs 1.1366–2(a)(5)(i), (ii) and (iii) are effective on and after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

[FR Doc. E7–18987 Filed 9–27–07; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–107592–00; REG–105964–98]

RIN 1545–BA11; RIN 1545–AW30

Consolidated Returns; Intercompany Obligations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and withdrawal of proposed regulations.

SUMMARY: This document contains proposed regulations that provide guidance regarding the treatment of transactions involving obligations between members of a consolidated group and the treatment of transactions involving the provision of insurance between members of a consolidated group. The regulations will affect corporations filing consolidated returns.

DATES: Written or electronic comments and requests for a public hearing must be received by December 27, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–107592–00), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–107592–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–107592–00).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments and/or requests for a public hearing, Kelly Banks (202) 622–7180; concerning the proposed regulations, Frances L. Kelly (202) 622–7770 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On July 18, 1995, final regulations (TD 8597) under § 1.1502–13 were published in the **Federal Register** [60 FR 36671], amending the intercompany transaction system of the consolidated return regulations. These final regulations included rules under § 1.1502–13(e) governing the treatment of insurance transactions between members of a consolidated group and rules under § 1.1502–13(g) governing the treatment of obligations between members of a consolidated group (the Current Regulations).

On December 21, 1998, a notice of proposed rulemaking (REG–105964–98) was published in the **Federal Register** [63 FR 70354], which proposed amendments to the intercompany obligation rules of § 1.1502–13(g) (the 1998 Proposed Regulations). After consideration of comments received regarding the Current Regulations and the 1998 Proposed Regulations, the IRS and the Treasury Department believe that the rules governing the treatment of intercompany obligations need to be revised. Accordingly, the IRS and the Treasury Department are withdrawing the 1998 Proposed Regulations and issuing these new proposed regulations in their place. However, for purposes of determining the tax treatment of transactions undertaken prior to the finalization of these proposed regulations, taxpayers may continue to rely upon the form and timing of the recast transaction, as clarified by the 1998 Proposed Regulations.

In addition, the IRS and the Treasury Department propose to revise certain of the rules under § 1.1502–13(e) that apply to intercompany transactions involving the provision of insurance between group members.

Explanation of Provisions

I. Intercompany Obligation Regulations

A. General Application

Section 1.1502–13(g) prescribes rules relating to the treatment of transactions involving intercompany obligations. An intercompany obligation is generally defined as an obligation between members of a consolidated group, but only for the period during which both the creditor and debtor are members of the group.

Section 1.1502–13(g) can apply to three types of transactions: (1) Transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation, such as the purchase by a consolidated group member of another member's debt from a nonmember creditor or the acquisition by a consolidated group member of stock of a nonmember creditor or debtor (inbound transactions); (2) transactions in which an intercompany obligation ceases to be an intercompany obligation, such as the sale by a creditor member of another member's debt to a nonmember or the deconsolidation of either the debtor or creditor member (outbound transactions); and (3) transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions).

B. The Deemed Satisfaction-Reissuance Model—Current Regulations and 1998 Proposed Regulations

For all three types of transactions—inbound, outbound, and intragroup—the Current Regulations and the 1998 Proposed Regulations generally provide that an obligation is treated as satisfied and, if the obligation remains outstanding, reissued as a new obligation (the deemed satisfaction-reissuance model). These regulations are intended to minimize the effects of intercompany obligations on a consolidated group's taxable income.

For inbound transactions, the deemed satisfaction-reissuance model mirrors the mechanics and single-entity policies underlying the section 108(e)(4) regulations. However, in contrast to those regulations, the deemed satisfaction-reissuance model also applies to obligations acquired for a premium and governs the treatment of the creditor as well as the debtor.

For outbound transactions, the deemed satisfaction-reissuance model furthers single-entity treatment by treating a consolidated group as a single issuer, and an intercompany obligation acquired or assumed by a nonmember as newly-issued debt. Thus, if a nonmember purchases an intercompany obligation at a discount, the nonmember will be treated as having acquired a new instrument with original issue discount to which section 1272 applies rather than market discount to which sections 1276 through 1278 apply.

For all three types of transactions, the deemed satisfaction-reissuance model preserves the location of a creditor and debtor member's items from an intercompany obligation, matches the timing of such items, and ensures that future items of original issue discount or premium between the creditor and debtor will similarly correspond in amount and timing.

Since the issuance of the 1998 Proposed Regulations, the IRS and the Treasury Department have considered whether, with respect to intragroup transactions, the objectives of § 1.1502–13(g) could be better accomplished without a deemed satisfaction-reissuance model, and could instead be achieved solely through the matching and acceleration principles of § 1.1502–13. After considering this approach, it was determined that special rules (in addition to the matching rule of § 1.1502–13(c) and the acceleration rule of § 1.1502–13(d)) would be necessary to ensure that transactions involving intercompany obligations clearly reflect consolidated taxable income. For example, if an intercompany obligation is sold to another member, the special rules and elections of the various debt regimes (that is, the rules for original issue discount, market discount, and acquisition premium) would have to be reconciled with the intercompany transaction rules through coordinating adjustments among the selling creditor, debtor, buying creditor, and any subsequent member creditors. The IRS and the Treasury Department have concluded that the deemed satisfaction-reissuance model is preferable to the complexity inherent in any such special rules.

Nonetheless, the IRS and the Treasury Department also have concluded that the deemed satisfaction-reissuance model can be improved in several respects. First, with respect to intragroup and outbound transactions, the mechanics of the model can be simplified and the amount for which an intercompany obligation is satisfied and reissued can be clarified. Second, the application of the model can be limited to those transactions for which its purposes are essential. Accordingly, these proposed regulations provide several exceptions to the application of the deemed satisfaction-reissuance model.

With respect to inbound transactions, the IRS and the Treasury Department have concluded that the mechanics of the deemed satisfaction-reissuance model and its application produce appropriate results and, therefore, no change has been proposed (except for the addition of a subgroup exception described in part I.H. of this preamble).

C. Revised Deemed Satisfaction-Reissuance Model for Intragroup and Outbound Transactions

1. Simplified Mechanics

Under the Current Regulations, and as revised under the 1998 Proposed Regulations, the mechanics of the deemed satisfaction and reissuance model are the same for both intragroup and outbound transactions. These mechanics generally treat an intercompany obligation as satisfied before an intragroup or outbound transaction and, if the obligation remains outstanding, reissued immediately after the transaction. Because these mechanics may affect the treatment of the actual transaction, they create uncertainties that have raised concerns among taxpayers.

To address these concerns, these proposed regulations adopt new and more precise mechanics for the application of the deemed satisfaction-reissuance model to certain intragroup and outbound transactions (or ''triggering transactions'' as described in part I.D. of this preamble). In general, the new model deems the following sequence of events to occur immediately before, and independently of, the actual transaction: (1) The debtor is deemed to satisfy the obligation for a cash amount equal to the obligation's fair market value; and (2) the debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount. The parties are then treated as engaging in the actual transaction but with the new obligation. For example, assume that S holds a B note with an adjusted issue price and basis of $100 and a fair market value of $70, and that S sells the B note to nonmember X for $70. Under the new deemed satisfaction-reissuance model, B is deemed, immediately before the sale to X, to satisfy the note for its fair market value of $70, resulting in $30 of cancellation of indebtedness income for B and $30 of loss for S (which is treated as ordinary loss under the attribute redetermination rule of § 1.1502–13(c)(4)(i)). B is then treated as reissuing to S a new note with identical terms for $70 and S is treated as selling this new note to X.

By separating the deemed satisfaction and reissuance from the actual transaction in which the obligation is transferred, the new model avoids confusion regarding whether or how the deemed satisfaction proceeds are integrated with the actual transaction. The new model operates to trigger all built-in items arising from the obligation, and then reissue the obligation with an issue price equal to its basis (and generally, its fair market value) before the actual transaction. Thus, no further gain, loss, income, or deduction with respect to the obligation will result from the actual transaction. In the example above, because S has a basis in the new B note of $70, S recognizes no gain or loss in the actual sale of the note to X, and X acquires the new B note with original issue discount of $30. See section 1278(a)(2)(B) (coordination where bond has original issue discount). After the obligation is deemed satisfied and reissued, the occurrence of the actual transaction does not result in an additional deemed satisfaction and reissuance.

2. The Deemed Satisfaction-Reissuance Amount

The Current Regulations and the 1998 Proposed Regulations provide that the deemed satisfaction and reissuance amount generally should be determined using the original issue discount principles of sections 1273 and 1274. The IRS and the Treasury Department have concluded, however, that for transactions where it is appropriate to require a deemed satisfaction and reissuance, the deemed satisfaction and reissuance amount generally should be equal to the obligation's fair market value.

The IRS and the Treasury Department acknowledge the inherent difficulty in valuing intercompany obligations. Nonetheless, the use of fair market value pricing more accurately preserves the location of a creditor and debtor member's items from an intercompany obligation and results in less distortion of the members' income, particularly where the issue price and value of the obligation differ significantly. Furthermore, in many transactions to which the deemed satisfaction-reissuance model applies under these proposed regulations, the group will often be required to determine the fair market value of the intercompany obligation because there is a taxable exchange of property for which the appropriate amount of gain or loss must be determined under general Internal Revenue Code (Code) principles. Accordingly, the IRS and the Treasury Department generally believe that requiring a deemed satisfaction and reissuance at fair market value will not be overly burdensome.

However, these proposed regulations also provide that where the creditor's amount realized with respect to the intercompany obligation in the transaction differs from the fair market value of the obligation, and the transaction is not an intragroup exchange of an intercompany obligation for a newly issued intercompany obligation, the deemed satisfaction and reissuance amount is the amount realized. For example, the amount realized with respect to an intercompany obligation may differ from fair market value if the creditor sells the obligation in a transaction to which section 1060 applies. In such cases, the use of amount realized rather than fair market value as the satisfaction amount for the deemed satisfaction and reissuance ensures that no additional items with respect to the obligation will result from the actual transaction.

If the transaction is an intragroup exchange of an intercompany obligation for a newly issued intercompany obligation, these proposed regulations provide that the obligation is deemed satisfied and reissued for its fair market value. In addition, for all such intragroup debt exchanges (other than routine intragroup debt modifications as discussed in part I.D.4 of this preamble), the newly issued obligation will be treated as having an issue price equal to its fair market value.

In addition, if a member's amount realized with respect to an intercompany obligation results from a mark to fair market value under section 475, then the obligation will be treated as satisfied and reissued under these regulations but will not otherwise be marked to fair market value under section 475 immediately thereafter. Because the deemed satisfaction and reissuance causes all built-in items from the obligation to be recognized, there is no need for an additional mark to fair market value under section 475. However, the rules of section 475 will continue to apply to the newly-reissued obligation with respect to future events.

These proposed regulations do not provide specific rules for intercompany obligations that are not debt instruments. The regulations generally provide that the principles applied to debt instruments will similarly apply (with appropriate adjustments) to such non-debt instruments. The IRS and the Treasury Department request comments on whether additional rules are needed for such instruments.

D. Limitations on the Application of the Deemed Satisfaction-Reissuance Model to Intragroup Transactions

The Current Regulations and the 1998 Proposed Regulations apply the deemed satisfaction-reissuance model to intragroup transactions in which a member realizes an amount (under the Current Regulations, an amount of income, gain, deduction, or loss, other than zero) with respect to an intercompany obligation from the assignment or extinguishment of all or part of its remaining rights or obligations under the intercompany obligation (or from a comparable transaction).

These proposed regulations generally retain the deemed satisfaction-reissuance model for such intragroup transactions. Specifically, these proposed regulations apply the model upon a ''triggering transaction,'' which is defined as any intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation (or from a comparable transaction). However, in recognition of the administrative burden involved in valuing intercompany obligations in certain transactions and in order to limit the effects of § 1.1502–13(g) on certain routine intragroup transactions involving intercompany obligations (such as an intragroup merger of one member into another), these proposed regulations provide a number of exceptions from the application of the deemed satisfaction and reissuance model (subject to the material tax benefit rule described in part I.E. of this preamble).

In general, and as further described in this preamble, the IRS and the Treasury Department have sought to apply the deemed satisfaction-reissuance model only to those intragroup transactions that have the greatest potential to create distortions of consolidated taxable income and to exclude those transactions where the administrative burdens of either requiring precise valuation of intercompany obligations or requiring the additional mechanics of the deemed satisfaction-reissuance model outweigh the benefits of increased precision. The IRS and the Treasury Department request comments as to whether some or all of these exceptions are appropriate, as well as suggestions for other exceptions.

1. Intragroup Sections 332, 351, and 361 Exchanges

Under these proposed regulations, and subject to the material tax benefit rule as described in part I.E. of this preamble, assignments of intercompany obligations in certain intragroup nonrecognition transactions are excepted from the application of the deemed satisfaction-reissuance model. These transactions include transfers and assumptions of intercompany obligations in intragroup exchanges to which section 332 or section 361 apply if neither the creditor nor the debtor recognizes an amount of income, gain, deduction, or loss in the transaction, or in intragroup exchanges to which section 351 applies if no such amount is recognized by the creditor.

2. Intragroup Taxable Assumption Transactions

These proposed regulations also provide an exception to the application of the deemed satisfaction-reissuance model for taxable intragroup sales of assets where intercompany obligations are assumed as part of the transaction. Where indebtedness is assumed incident to a sale of assets, in most cases, the location of gain or loss from an intercompany obligation is appropriately reflected in increased or reduced sales proceeds for the assets. Such transactions generally present less potential for distortion of consolidated taxable income. Accordingly, subject to the material tax benefit rule as described in part I.E. of this preamble, the regulations do not require a deemed satisfaction and reissuance where an intercompany obligation is assumed in a taxable intragroup sale of assets.

3. Intragroup Extinguishments—In General

These proposed regulations except from the application of the deemed-satisfaction reissuance model many intragroup transactions in which an intercompany obligation is extinguished. In general, where an intercompany obligation is extinguished, the Code and regulations will cause the creditor and debtor to recognize their respective items from the obligation, and thus preserve the location of such items. In such cases, a deemed satisfaction-reissuance model is not necessary. Thus, under these proposed regulations and subject to the material tax benefit rule as described in part I.E. of this preamble, the deemed satisfaction-reissuance model does not apply where the adjusted issue price of the obligation is equal to the creditor's basis in the obligation and the creditor's and debtor's items from the extinguishment transaction offset in amount.

These proposed regulations provide that certain Code provisions, such as section 108(a) and section 354 are inapplicable to gains and losses from intercompany obligations (and clarify that section 355(a)(1) is also inapplicable to such gains and losses). Turning off these provisions ensures single entity treatment by correcting mismatches that occur under the Code (where, for instance, a debtor has discharge of indebtedness income from the retirement of a security but the creditor's corresponding loss is not recognized) and requiring immediate recognition of both the debtor's and the creditor's items. The Current Regulations and the 1998 Proposed Regulations also provide that these Code provisions are inapplicable in many circumstances.

In the context of extinguishment transactions, the ''turn-off'' rule in these proposed regulations is applied first to determine whether the transaction is a triggering transaction. Because the rule imposes symmetrical treatment of the debtor and the creditor and requires that each member recognize their respective items, in many cases the debtor's and creditor's items will offset in amount and the exception described above will apply. For example, assume a note with an adjusted issue price and basis of $100 is extinguished in a fully taxable transaction for $20 and that the debtor's cancellation of indebtedness income would otherwise be excluded under section 108(a). Because the turn-off rule makes section 108(a) inapplicable, the creditor's $80 loss and the debtor's $80 of cancellation of indebtedness income will offset in amount and the extinguishment transaction will not be subject to the deemed satisfaction and reissuance model.

However, the deemed satisfaction-reissuance model will continue to apply in those cases where, after taking into account the above-described ''turn-off'' rule, the creditor's and debtor's items from the transaction do not offset in amount. In these cases, depending upon the circumstances, the net amount of income, gain, loss, or deduction from the intercompany obligation may or may not be redetermined, under the principles of § 1.1502–13(c)(1), to be excluded from gross income or treated as a noncapital, nondeductible amount.

4. Routine Intragroup Modifications of Intercompany Obligations

In general, the exchange of intercompany debt for newly issued intercompany debt presents a high potential for distortion of consolidated taxable income. Accordingly, these proposed regulations apply the deemed satisfaction-reissuance model at fair market value to such intragroup exchanges and generally provide that the newly issued obligation will be treated as issued for its fair market value. However, in order to avoid requiring valuation of intercompany obligations in routine debt modifications, the proposed regulations provide an exception for certain debt-for-debt exchanges involving a single issuer, subject to the material tax benefit rule as described in part I.E. of this preamble. Thus, if a member's intercompany debt is extinguished in exchange (or deemed exchange) for the member's newly issued intercompany debt, and the issue price of the new debt is equal to both the adjusted issue price and basis of the extinguished debt, the deemed satisfaction-reissuance model does not apply (and the newly issued debt is not treated as issued for its fair market value).

5. Other Exceptions for Intragroup Transactions

These proposed regulations retain the exceptions in the Current Regulations for transactions involving an obligation that became an intercompany obligation by reason of an event described in § 1.108–2(e), and for amounts realized from reserve accounting under section 585. However, consistent with the 1998 Proposed Regulations, these proposed regulations do not include the exception in the Current Regulations for transactions in which the deemed satisfaction and reissuance will not have a significant effect on any person's Federal income tax liability for any year.

E. Material Tax Benefit Rule

Although these proposed regulations provide exceptions to the deemed satisfaction-reissuance model, the IRS and the Treasury Department remain concerned that the shifting of built-in items from intercompany obligations can give rise to significant potential for distortion. Intercompany obligations present special concerns because debt between members never increases or diminishes the wealth of the group (one member's economic gain is matched by the other's economic loss) and because, in comparison to other types of property, they can be easily created, transferred, modified, and extinguished within the group at little or no economic cost.

Therefore, in order to prevent distortions that may result from the shifting of built-in items from intercompany obligations, these proposed regulations include a special rule (the material tax benefit rule) that applies to intragroup transactions otherwise excepted from the deemed satisfaction-reissuance model under the exceptions for certain intragroup nonrecognition exchanges, taxable assumption transactions, extinguishment transactions, and routine debt modifications as described in parts I.D.1, 2, 3 and 4 of this preamble. The rule is directed at intragroup transactions that would have a distortive effect on members' attributes or the basis of member stock using built-in items from intercompany obligations.

The material tax benefit rule generally applies to an intragroup assignment or extinguishment that would otherwise be excepted from the deemed satisfaction-reissuance model if, at the time of the transaction, it is reasonably foreseeable (regardless of intent) that the shifting of items of built-in gain, loss, income, or deduction from an intercompany obligation between members will secure a material tax benefit that would not otherwise be enjoyed. In such cases, the intercompany transaction will be treated as a ''triggering transaction'' and will be subject to the deemed satisfaction-reissuance model as described in part I.C. of this preamble.

F. Off-Market Issuance Rule

The IRS and the Treasury Department also believe that inappropriate distortions of consolidated taxable income could result from intercompany obligations that are issued at a materially off-market rate of interest. Such lending transactions may create built-in gain or loss in a newly issued obligation that could facilitate the manipulation of a member's attributes or the basis of member stock. Although off-market lending transactions are subject to various limitations under the Code and regulations (for example, sections 482, 1274, and 7872), the IRS and the Treasury Department believe that an additional rule is necessary to properly reflect consolidated taxable income.

Accordingly, these proposed regulations include a special rule (the off-market issuance rule) that generally applies if an intercompany obligation is issued at a rate of interest that is materially off-market, and at the time of issuance, it is reasonably foreseeable that the shifting of built-in items from the obligation from one member to another member will secure a material tax benefit. In such cases, the intercompany obligation will be treated as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor member and the debtor member at the time of issuance (for example, as a distribution or a contribution to capital). This rule is not intended to apply to intragroup lending at interest rates that approximate those that would have been charged in an arm's length transaction.

The IRS and the Treasury Department are continuing to explore the relationship between the intragroup off-market issuance rule and the other limitations imposed by the Code and regulations on such lending transactions, and request comments in this regard.

G. Outbound Transactions

These proposed regulations have retained the deemed satisfaction-reissuance model (with the aforementioned new mechanics) for outbound transactions, as well as the exception in the Current Regulations for outbound transactions involving an obligation that became intercompany obligation in an event described in § 1.108–2(e). These proposed regulations also include two additional exceptions applicable to outbound transactions.

The first, the subgroup exception, provides that the deemed satisfaction and reissuance model will not apply if the creditor and debtor to an intercompany obligation cease to be members of a consolidated group in a transaction in which neither member otherwise recognize an item with respect to the intercompany obligation, and immediately after the transaction, such creditor and debtor are members of another consolidated group. In such cases, a deemed satisfaction and reissuance is unnecessary because any built-in items with respect to the obligation will be appropriately preserved and offset in the new consolidated group. However, to minimize distortions in the new group that may result from these built-in items (for example, if S and B are acquired in different chains), the exception requires that the creditor and the debtor bear a relationship described in section 1504(a)(1) to each other through an intercompany obligation subgroup parent (which may be the debtor or the creditor).

These proposed regulations provide a second exception for an intercompany obligation that is newly issued in an intragroup reorganization and pursuant to the plan of reorganization, is distributed to a nonmember shareholder or creditor in a transaction to which section 361(c) applies. Because the obligation is newly issued in the reorganization and is distributed outside of the group as part of the same plan, the IRS and the Treasury Department believe that a deemed satisfaction and reissuance of the obligation is not necessary to carry out the purposes of § 1.1502–13.

These proposed regulations also provide a rule that prevents indirect acceleration of a loss from an intercompany obligation through the sale of the obligation to a nonmember in exchange for a newly-issued obligation (the issue price of which is determined under section 1273(b)(4) or section 1274(a)) followed by a sale of the nonmember obligation at a loss. The regulations under section 108(e)(4) contain a similar rule.

H. Inbound Transactions

Both the Current Regulations and the 1998 Proposed Regulations apply a deemed satisfaction-reissuance model for transactions in which a nonintercompany obligation becomes an intercompany obligation. For such transactions, the obligation is treated as satisfied and reissued immediately after it becomes an intercompany obligation.

These proposed regulations retain the deemed satisfaction-reissuance model for inbound transactions, but also include a ''subgroup'' exception for certain of these transactions. The subgroup exception for inbound transactions is similar to the subgroup exception for outbound transactions as described in part I.G. of this preamble.

In addition, these proposed regulations provide a special rule to prevent inappropriate acceleration of a deduction for repurchase premium in certain inbound transactions. A single corporation that repurchases its own debt in exchange for a newly-issued debt, the issue price of which is determined under either section 1273(b)(4) or section 1274, must amortize any repurchase premium over the term of the newly-issued debt instrument. See § 1.163–7(c). Because the IRS and the Treasury Department believe that it would be inconsistent with single-entity principles to permit consolidated groups an immediate deduction in similar circumstances, these proposed regulations provide that if indebtedness of a member is acquired in exchange for the issuance of indebtedness to a nonmember and the issue price of the newly-issued indebtedness is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or section 1274(a)), then the repurchase premium from the deemed satisfaction will be amortized over the term of the obligation issued to the nonmember.

I. Other Request for Comments

In general, these proposed regulations retain the definition of intercompany obligation found in the Current Regulations and the 1998 Proposed Regulations. This definition excludes executory obligations to purchase or provide goods or services. The IRS and the Treasury Department are considering whether this exclusion is appropriate in all instances, and request comments in this regard.

As described in part I.G. of this preamble, these proposed regulations except from the deemed satisfaction-reissuance model outbound transfers of intercompany obligations where the obligation is newly issued in an intragroup reorganization and is then distributed to a nonmember shareholder or creditor in a transaction to which section 361(c) applies. These proposed regulations do not provide an exception for such transactions where the newly issued obligation is distributed within the group to a member shareholder or creditor. The IRS and the Treasury Department are studying the effects of the deemed satisfaction-reissuance model on such intragroup distributions and are considering various approaches to ensure the appropriate single-entity treatment of such transactions. Comments are requested in this regard.

These proposed regulations do not provide special rules for the treatment of intercompany obligations transferred or assumed in transactions under section 338. The IRS and the Treasury

Department request comments in this regard.

The application of the deemed satisfaction-reissuance model and the matching principles of § 1.1502–13(c) generally align the basis and issue price (or adjusted issue price) of an intercompany obligation and, thus, reduce potential distortions. For newly issued obligations, however, in certain circumstances the Code and regulations produce disparities between issue price and basis (such as the issuance of note by a subsidiary to its parent in a distribution to which section 301 applies). The IRS and the Treasury Department are considering whether it would be beneficial to eliminate any such disparity created upon the issuance of an obligation (for example, by treating such obligations as issued for fair market value) and request comments in this regard.

II. Intercompany Insurance Regulations

A. Current Regulations

Under the Current Regulations, a member's special status as an insurance company is respected and, in some circumstances, results in an exception to the general single entity treatment for intercompany transactions. Under § 1.1502–13(e)(2)(ii)(A), if a member provides insurance to another member in an intercompany transaction, the transaction is taken into account on a separate entity basis. Thus, premiums, reserve increases and decreases, and other similar items are determined and taken into account under the members' separate entity method of accounting rather than under the matching rule of § 1.1502–13(c) and the acceleration rule of § 1.1502–13(d). It was believed that such transactions would not have a substantial effect on consolidated taxable income, and therefore, it was appropriate to except these transactions from single entity treatment. This exception was intended to avoid the complexity that would result from adjustments needed to produce single entity results, and, thus, simplify intercompany accounting. See CO–11–91, 1994–1 CB 724 [59 FR 18011]. However, except with respect to the amount of any reserve item listed in section 807(c) or section 832(b)(5) resulting from an intercompany reinsurance transaction, this departure from single entity treatment does not extend to intercompany reinsurance transactions. See § 1.1502–13(e)(2)(ii)(B).

Subsequent to the issuance of the Current Regulations, the IRS determined that it would no longer invoke the ''economic family theory'' in addressing whether captive insurance transactions constituted insurance for federal income tax purposes. Rev. Rul. 2001–31 (2001–1 C.B. 1348), (See § 601.601(d)(2)(ii)(*b*).) In addition, the IRS and the Treasury Department have become aware of the increasing prevalence of captive insurance arrangements within consolidated groups. Thus, the separate entity treatment of insurance payments from one member of a group to a captive insurance member may now have a greater effect on consolidated taxable income than was anticipated when the Current Regulations were issued.

B. Single Entity Treatment for Significant Insurance Members

The IRS and the Treasury Department believe that separate entity treatment for direct insurance transactions is inappropriate where a significant amount of the insuring member's business arises from transactions with other group members. Accordingly, these proposed regulations provide that, where a significant portion (5 percent or more) of the business of the insuring member (in such case, a ''significant insurance member'') arises from insuring the risks of other members (either by issuing insurance contracts directly to members or by reinsuring risks on contracts issued to members), it is appropriate to take into account the items from the intercompany transactions on a single entity basis. In such cases, the treatment of the members' items from the insurance transactions are subject to the matching and acceleration rules of § 1.1502–13.

Under these rules, the insured member's deduction and the significant insurance member's income from the transaction will generally be taken into account currently. However, the effects of the intercompany transaction will otherwise be treated in a manner comparable to ''self-insurance'' by a single corporation. For example, the significant insurance member's discounted unpaid losses under section 832(b)(5) will be determined without regard to the intercompany insurance transaction, and such member will instead take deductions with respect to losses incurred on intercompany insurance under the principles of sections 162 and 461. On the other hand, if a significant insurance member assumes all or a portion of the risk on an insurance contract written by another member with respect to risks of a nonmember, then under single entity principles, these proposed regulations generally permit the significant insurance member to increase its reserve item under section 807(c) or 832(b)(5) with respect to the premium payment.

These proposed regulations continue to except intercompany insurance transactions from single entity treatment where intercompany insurance represents less than 5 percent of the insuring member's business.

Reinsurance transactions engaged in by group members that attempt to circumvent the single entity rules of § 1.1502–13(e) may be subject to the anti-avoidance rules of § 1.1502–13(h). Thus, for example, if a member enters into an insurance contract with a third-party insurer and the contract is then reinsured with a member of the group in order to avoid treatment as an intercompany transaction, appropriate adjustments will be made to carry out the purposes of the intercompany transaction regulations. See also section 845, which allows the Secretary to allocate, recharacterize, or make other adjustments with respect to two or more related persons who are parties to a reinsurance agreement in order to reflect the proper amount, source, or character of taxable income related to such an agreement, or to make proper adjustments with respect to a party to a reinsurance contract if the contract has a significant tax avoidance effect.

C. Request for Comments

The determination of whether an insuring member is a ''significant insurance member'' and, therefore, is subject to the special rules described above, is made on an annual basis by comparing the amount of the insuring member's business that arises from insuring the risks of other members with its total insurance business. In making this determination, these proposed regulations use an amount determined under section 832(b)(4)(A) (gross premiums written during the taxable year less return premiums and premiums paid for reinsurance) to measure the insuring member's annual insurance business. The IRS and the Treasury Department request comments as to whether this is an appropriate measure of an insuring member's business, as well as suggestions for alternatives. The IRS and the Treasury Department are also considering whether the status of an insuring member as a ''significant insurance member'' should be an annual determination and whether additional rules are needed when an insuring member's status changes. The IRS and the Treasury Department request comments in this regard, in addition to whether any additional special rules are needed to accomplish single entity treatment for intercompany insurance transactions.

Proposed Effective/Applicability Date and Reliance

These proposed regulations under § 1.1502–13(g) apply to transactions involving intercompany obligations occurring in consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**. However, for purposes of determining the tax treatment of transactions undertaken prior to the finalization of these proposed regulations, taxpayers may continue to rely upon the form and timing of the recast transaction, as clarified by the 1998 Proposed Regulations (REG–105964–98) [63 FR 70354].

These proposed regulations under § 1.1502–13(e) apply to intercompany transactions involving the provision of insurance occurring in consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses, and, moreover, that any burden on taxpayers is minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Frances L. Kelly, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Proposed Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–105964–98) that was published in the **Federal Register** on Monday, December 21, 1998, [63 FR 70354] is withdrawn.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding the following entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.1502–13 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–13 is amended by:

1. Revising the fifth paragraph heading, each entry for Examples 1 through 5, and adding new Examples 6 through 11 in the table of examples in paragraph (a)(6)(ii).
2. Revising the first sentence of paragraph (e)(2)(i).
3. Adding new paragraph (e)(2)(ii)(C).
4. Revising paragraph (g).
5. Removing paragraph (j)(9) *Example 5(c)*.

The addition and revisions read as follows:

§ 1.1502–13 Intercompany transactions.

(a) * * *
(6) * * *
(ii) * * *

* * * * *

Obligations of members. (§ 1.1502–13(g)(7)(ii))

Example 1. Interest on intercompany obligation.
Example 2. Intercompany obligation becomes nonintercompany obligation.
Example 3. Loss or bad debt deduction with respect to intercompany obligation.
Example 4. Intercompany nonrecognition transactions.
Example 5. Assumption of intercompany obligation.
Example 6. Extinguishment of intercompany obligation.
Example 7. Exchange of intercompany obligations.
Example 8. Material tax benefit rule.
Example 9. Issuance at off-market rate of interest.
Example 10. Nonintercompany obligation becomes intercompany obligation.
Example 11. Notional principal contracts.

* * * * *

(e) * * *

(2) * * * (i) * * * Except as provided in paragraph (g)(4)(v) of this section (deferral of items from an intercompany obligation), a member's addition to, or reduction of, a reserve for bad debts that is maintained under section 585 is taken into account on a separate entity basis. * * *

(ii) * * *

(C) *Significant insurance member*—(*1*) *Single entity treatment for direct insurance and reinsurance*. If a significant insurance member (as defined in paragraph (e)(2)(ii)(*C*)(*2*)(*i*) of this section) insures the risk of another member (the insured member) in an intercompany transaction, paragraphs (e)(2)(ii)(A) and (B) of this section do not apply and the intercompany transaction is taken into account by both members on a single entity basis. For example, the timing and attributes of items from a premium payment from an insured member to a significant insurance member will be taken into account under the matching and acceleration rules, and the premiums earned with respect to the intercompany payment will not be accounted for by the significant insurance member under the rules of section 832(b)(4). The significant insurance member's deduction for losses incurred with respect to the intercompany insurance will be taken into account under the rules of sections 162 and 461 (including § 1.461–2), rather than section 832(b)(5). However, under single-entity principles, if a significant insurance member assumes all or a portion of the risk on an insurance contract written by another member with respect to risks of a nonmember, then the matching and acceleration rules will generally permit the significant insurance member to increase its reserve item under section 807(c) or 832(b)(5) with respect to the premium payment.

(*2*) *Definitions*. For purposes of this paragraph (e)(2)(ii)(C), the following definitions apply:

(*i*) *Significant insurance member*. A member is a significant insurance member if it is an insurance company subject to tax under subchapter L and five percent or more of the member's insurance premiums written during the taxable year arise from insuring risks of other members of the group.

(*ii*) *Insurance premiums written during the taxable year* means gross premiums written (as defined in § 1.832–4(a)(4) and as reported by the insuring member under the method prescribed by § 1.832–4(a)(5)) on insurance contracts during the taxable year, less return premiums (as defined in § 1.832–4(a)(6)) and premiums paid for reinsurance.

(*3*) *Effective/applicability date.* The rules of this paragraph (e)(2)(ii)(C) apply to intercompany transactions involving the provision of insurance occurring in consolidated return years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

(g) *Obligations of members*—(1) *In general.* In addition to the general rules of this section, the rules of this paragraph (g) apply to intercompany obligations.

(2) *Definitions.* For purposes of this section, the following definitions apply:

(i) *Obligation of a member* is a debt or security of a member.

(A) *Debt of a member* is any obligation of the member constituting indebtedness under general principles of Federal income tax law (for example, under nonstatutory authorities, or under section 108, section 163, or § 1.1275–1(d)), but not an executory obligation to purchase or provide goods or services.

(B) *Security of a member* is any security of the member described in section 475(c)(2)(D) or (E), and any commodity of the member described in section 475(e)(2)(A), (B), or (C), but not if the security or commodity is a position with respect to the member's stock. See paragraphs (f)(4) and (f)(6) of this section for special rules applicable to positions with respect to a member's stock.

(ii) *Intercompany obligation* is an obligation between members, but only for the period during which both parties are members.

(iii) *Intercompany obligation subgroup* is comprised of two or more members that include the creditor and debtor on an intercompany obligation if the creditor and debtor bear the relationship described in section 1504(a)(1) to each other through an intercompany obligation subgroup parent.

(iv) *Intercompany obligation subgroup parent* is the corporation (including either the creditor or debtor) that bears the same relationship to the other members of the intercompany obligation subgroup as a common parent bears to the members of a consolidated group. Any reference to an intercompany obligation subgroup parent includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction to which section 381(a) applies.

(v) *Material tax benefit* is the benefit of a material net reduction in income or gain, or a material net increase in loss, deduction, credit, or allowance. A material tax benefit includes, but is not limited to, the use of a built-in item or items from an intercompany obligation to materially reduce gain or increase loss on the sale of member stock, or to create or absorb a material tax attribute of a member or subgroup.

(3) *Deemed satisfaction and reissuance of intercompany obligations in triggering transactions*—(i) *Scope*—(A) *Triggering transactions.* For purposes of this paragraph (g)(3), a triggering transaction includes the following:

(*1*) *Assignment and extinguishment transactions.* Any intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation or any comparable transaction in which a member realizes any such amount, directly or indirectly, from an intercompany obligation (for example, a mark to fair market value of an obligation or a bad debt deduction). However, a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and § 1.1502–28 (basis reductions upon the exclusion from gross income of discharge of indebtedness) or any other provision that adjusts the basis of an intercompany obligation as a substitute for income, gain, deduction, or loss, is not a comparable transaction.

(*2*) *Outbound transactions.* Any transaction in which an intercompany obligation becomes an obligation that is not an intercompany obligation.

(B) *Exceptions.* Except as provided in paragraph (g)(3)(i)(C) of this section, a transaction is not a triggering transaction as described in paragraph (g)(3)(i)(A) of this section if any of the exceptions in this paragraph (g)(3)(i)(B) apply. In making this determination, if a creditor or debtor realizes an amount in a transaction in which a creditor assigns all or part of its rights under an intercompany obligation to the debtor, or a debtor assigns all of or part of its obligations under an intercompany obligation to the creditor, the transaction will be treated as an extinguishment and will be excepted from the definition of ''triggering transaction'' only if either of the exceptions in paragraphs (g)(3)(i)(B)(*5*) or (*6*) of this section apply.

(*1*) *Intragroup section 332, 351, or 361 exchange.* The transaction is an intercompany exchange to which section 332 or section 361 applies in which no amount of income, gain, deduction or loss is recognized by the creditor or debtor, or an intercompany exchange to which section 351 applies in which no such amount is recognized by the creditor (unless section 362(e)(2) applies to the exchange).

(*2*) *Intragroup assumption transaction.* All of the debtor's obligations under an intercompany obligation are assumed in connection with the debtor's sale or other disposition of property (other than money) in an intercompany transaction to which section 1001 applies.

(*3*) *Exceptions to the application of section 108(e)(4).* The obligation became an intercompany obligation by reason of an event described in § 1.108–2(e) (exceptions to the application of section 108(e)(4)).

(*4*) *Reserve accounting.* The amount realized is from reserve accounting under section 585 (see paragraph (g)(4)(v) of this section for special rules).

(*5*) *Intragroup extinguishment transaction.* All or part of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction (other than an exchange or deemed exchange of an intercompany obligation for a newly issued intercompany obligation), the adjusted issue price of the obligation is equal to the creditor's basis in the obligation, and the debtor's corresponding item and the creditor's intercompany item (after taking into account the special rules of paragraph (g)(4)(i)(C) of this section) with respect to the obligation offset in amount.

(*6*) *Routine modification of intercompany obligation.* All of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction that is an exchange (or deemed exchange) for a newly issued intercompany obligation, and the issue price of the newly issued obligation equals both the adjusted issue price of the extinguished obligation and the creditor's basis in the extinguished obligation.

(*7*) *Outbound distribution of newly issued intercompany obligation.* The intercompany obligation becomes an obligation that is not an intercompany obligation in a transaction in which a member that is a party to the reorganization exchanges property in pursuance of the plan of reorganization for a newly issued intercompany obligation of another member that is a party to the reorganization and distributes such intercompany obligation to a nonmember shareholder or nonmember creditor in a transaction to which section 361(c) applies.

(*8*) *Outbound subgroup exception*. The intercompany obligation becomes an obligation that is not an intercompany obligation in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the intercompany obligation, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.

(C) *Material tax benefit rule*. If an assignment or extinguishment of an intercompany obligation in an intercompany transaction would otherwise be excepted from the definition of triggering transaction under paragraph (g)(3)(i)(B)(*1*), (*2*), (*5*), or (*6*) of this section, but at the time of the assignment or extinguishment, it is reasonably foreseeable that the shifting of items of built-in gain, loss, income, or deduction from the obligation from one member to another member will secure a material tax benefit (as defined in paragraph (g)(2)(v) of this section) that the group or its members would not otherwise enjoy in a consolidated or separate return year, then the assignment or extinguishment will be a triggering transaction to which paragraph (g)(3)(ii) of this section applies.

(ii) *Application of deemed satisfaction and reissuance*. This paragraph (g)(3)(ii) applies if a triggering transaction occurs.

(A) *General rule*. If the intercompany obligation is debt of a member, then (except as provided in the following sentence) the debt is treated for all Federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to its fair market value, and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction. However, if the creditor realizes an amount with respect to the debt in the triggering transaction that differs from the debt's fair market value, and the triggering transaction is not an exchange (or deemed exchange) of debt of a member for newly issued debt of a member, then the debt is treated for all Federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to such amount realized, and reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction. If the triggering transaction is a mark to fair market value under section 475, then the intercompany obligation will be deemed satisfied and reissued for its fair market value (as determined under section 475 and applicable regulations) and section 475 will not otherwise apply with respect to that triggering transaction. If the intercompany obligation is a security of a member, similar principles apply (with appropriate adjustments) to treat the security as having been satisfied and reissued immediately before the triggering transaction.

(B) *Treatment as separate transaction*. The deemed satisfaction and reissuance is treated as a separate transaction from the triggering transaction. The deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for Federal income tax purposes immediately before the triggering transaction.

(4) *Special rules*—(i) *Timing and attributes*. For purposes of applying the matching rule and the acceleration rule to a transaction involving an intercompany obligation (other than a transaction to which paragraph (g)(5) of this section applies)—

(A) Paragraph (c)(6)(i) of this section (treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of the intercompany obligation pursuant to sections 108 and 1017 and § 1.1502–28, or any other provision that adjusts the basis of an intercompany obligation as a substitute for income or gain;

(B) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from the intercompany obligation from being excluded from gross income;

(C) Any income, gain, deduction, or loss from the intercompany obligation is not subject to section 108(a), section 354, section 355(a)(1), section 1091, or, in the case of an extinguishment of an intercompany obligation in a transaction in which the creditor transfers the obligation to the debtor in exchange for stock in such debtor, section 351(a); and

(D) Section 108(e)(7) does not apply upon the extinguishment of an intercompany obligation.

(ii) *Newly issued obligation in intragroup exchanges*. If an intercompany obligation is exchanged (or is deemed exchanged) for a newly issued intercompany obligation and the exchange (or deemed exchange) is not a routine modification of an intercompany obligation (as described in paragraph (g)(3)(i)(B)(*6*) of this section), then the newly issued obligation will be treated for all Federal income tax purposes as having an issue price equal to its fair market value.

(iii) *Off-market issuance*. If an intercompany obligation is issued at a rate of interest that is materially off-market (off-market obligation) and at the time of issuance, it is reasonably foreseeable that the shifting of items of built-in gain, loss, income, or deduction from the obligation from one member to another member will secure a material tax benefit (as defined in paragraph (g)(2)(v) of this section), then the intercompany obligation will be treated, for all Federal income tax purposes, as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor and the debtor at the time the obligation is issued. For example, if S lends $100 to B in return for an off-market B note with a value of $130, and at that time, it is reasonably foreseeable that a material tax benefit will be secured by the shifting of items from the note, then the B note will be treated as issued for $130. The $30 difference will be treated as a distribution or capital contribution between S and B (as appropriate) at the time of issuance, and this amount will be reflected in future payments on the note as bond issuance premium. An adjustment to an off-market obligation under this paragraph (g)(4)(iii) will be made without regard to the application of, and in lieu of any adjustment under, section 467 (certain payments for the use of property or services), 482 (allocations among commonly controlled taxpayers), 483 (interest on certain deferred payments), 1274 (determination of issue price for certain debt instruments issued for property), or 7872 (treatment of loans with below-market interest rates.

(iv) *Deferral of loss or deduction with respect to nonmember indebtedness acquired in certain debt exchanges*. If a creditor transfers an intercompany obligation to a nonmember (former intercompany obligation) in exchange for newly issued debt of a nonmember (nonmember debt), and the issue price of the nonmember debt is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law), then any loss of the creditor otherwise allowable on the subsequent disposition of the nonmember debt, or any comparable tax benefit that would otherwise be available in any other transaction that directly or indirectly results from the disposition of the nonmember debt, is deferred until the date the debtor retires the former intercompany obligation.

(v) *Bad debt reserve*. A member's deduction under section 585 for an addition to its reserve for bad debts with respect to an intercompany obligation is not taken into account, and is not treated as realized for purposes of paragraph (g)(3)(i)(A)(*1*) of this section, until the intercompany obligation is extinguished or becomes an obligation that is not an intercompany obligation.

(5) *Deemed satisfaction and reissuance of obligations becoming intercompany obligations*—(i) *Application of deemed satisfaction and reissuance*—(A) *In general*. This paragraph (g)(5) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

(B) *Exceptions*. This paragraph (g)(5) does not apply to an intercompany obligation if either of the following exceptions apply.

(*1*) *Exceptions to the application of section 108(e)(4)*. The obligation becomes an intercompany obligation by reason of an event described in § 1.108–2(e) (exceptions to the application of section 108(e)(4)); or

(*2*) *Inbound subgroup exception*. The obligation becomes an intercompany obligation in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the intercompany obligation, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.

(ii) *Deemed satisfaction and reissuance*—(A) *General rule*. If the intercompany obligation is debt of a member, then the debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany obligation, as having been satisfied by the debtor for cash in an amount determined under the principles of § 1.108–2(f), and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash. If the intercompany obligation is a security of a member, similar principles apply (with appropriate adjustments) to treat the security, immediately after it becomes an intercompany obligation, as satisfied and reissued by the debtor for cash in an amount equal to its fair market value.

(B) *Treatment as separate transaction*. The deemed satisfaction and reissuance is treated as a separate transaction from the transaction in which the debt becomes an intercompany obligation, and the tax consequences of the transaction in which the debt becomes an intercompany obligation must be determined before the deemed satisfaction and reissuance occurs. (For example, if the debt becomes an intercompany obligation in a transaction to which section 351 applies, any limitation imposed by section 362(e) on the basis of the intercompany obligation in the hands of the transferee member is determined before the deemed satisfaction and reissuance.) The deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for Federal income tax purposes.

(6) *Special rules*—(i) *Timing and attributes*. If paragraph (g)(5) of this section applies to an intercompany obligation—

(A) Section 108(e)(4) does not apply;

(B) The attributes of all items taken into account from the satisfaction of the intercompany obligation are determined on a separate entity basis, rather than by treating S and B as divisions of a single corporation; and

(C) Any intercompany gain or loss realized by the creditor is not subject to section 354 or section 1091.

(ii) *Waiver of loss carryovers from separate return limitation years*. Solely for purposes of § 1.1502–32(b)(4) and the effect of any election under that provision, any loss taken into account under paragraph (g)(5) of this section by a corporation that becomes a member as a result of the transaction in which the obligation becomes an intercompany obligation is treated as a loss carryover from a separate return limitation year.

(iii) *Deduction of repurchase premium in certain debt exchanges*. If an obligation to which paragraph (g)(5) of this section applies is acquired in exchange for the issuance of an obligation to a nonmember and the issue price of this newly issued obligation is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law), then, under the principles of § 1.163–7(c), any repurchase premium from the deemed satisfaction of the intercompany obligation under paragraph (g)(5)(ii) of this section will be amortized by the debtor over the term of the obligation issued to the nonmember in the same manner as if it were original issue discount and the obligation to the nonmember had been issued directly by the debtor.

(7) *Examples*—(i) *In general*. For purposes of the examples in this paragraph (g), unless otherwise stated, interest is qualified stated interest under § 1.1273–1(c), and the intercompany obligations are capital assets and are not subject to section 475.

(ii) The application of this section to obligations of members is illustrated by the following examples:

Example 1. Interest on intercompany obligation. (i) *Facts*. On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a $10 interest deduction annually under section 163, and S accrues $10 of interest income annually under section 61(a)(4) and § 1.446–2.

(ii) *Matching rule*. Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its $10 of income into account in each of years 1 through 5 to reflect the $10 difference between B's $10 of interest expense taken into account and the $0 recomputed expense. S's income and B's deduction are ordinary items. (Because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.)

(iii) *Original issue discount*. The facts are the same as in paragraph (i) of this *Example 1*, except that B borrows $90 (rather than $100) from S in return for B's note providing for $10 of interest annually and repayment of $100 at the end of year 5. The principles described in paragraph (ii) of this *Example 1* for stated interest also apply to the $10 of original issue discount. Thus, as B takes into account its corresponding expense under section 163(e), S takes into account its intercompany income under section 1272. S's income and B's deduction are ordinary items.

(iv) *Tax-exempt income*. The facts are the same as in paragraph (i) of this *Example 1*, except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies. The timing of S's income is the same as in paragraph (ii) of this *Example 1*. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item of disallowed interest expense control the attributes of S's offsetting intercompany interest income. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income because section 265(a)(2) permanently and explicitly disallows B's corresponding deduction and because, under paragraph (g)(4)(i)(B) of this section, paragraph (c)(6)(ii) of this section does not apply to prevent any intercompany income from the B note from being excluded from gross income. Accordingly, S's intercompany income is treated as excluded from gross income.

Example 2. Intercompany obligation becomes nonintercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has paid the interest accruing under the note and S sells B's note to X for $70, reflecting an increase in prevailing market interest rates. B is never insolvent within the meaning of section 108(d)(3).

(ii) *Deemed satisfaction and reissuance.* Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $70 immediately before S's sale to X. As a result of the deemed satisfaction of the note for less than its adjusted issue price, B takes into account $30 of discharge of indebtedness income under § 1.61–12. On a separate entity basis, S's $30 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's $30 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $70 issue price, a $100 stated redemption price at maturity, and a $70 basis in the hands of S. S is then treated as selling the new note to X for the $70 received by S in the actual transaction. Because S has a basis of $70 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new note held by X is not an intercompany obligation, it has a $70 issue price, a $100 stated redemption price at maturity, and a $70 basis. The $30 of original issue discount will be taken into account by B and X under sections 163(e) and 1272.

(iii) *Creditor deconsolidation.* The facts are the same as in paragraph (i) of this *Example 2*, except that P sells S's stock to X (rather than S selling B's note to X). Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its $70 fair market value immediately before S becomes a nonmember. The treatment of S's $30 of loss and B's $30 of discharge of indebtedness income is the same as in paragraph (ii) of this *Example 2.* The new note held by S upon deconsolidation is not an intercompany obligation, it has a $70 issue price, a $100 stated redemption price at maturity, and a $70 basis. The $30 of original issue discount will be taken into account by B and S under sections 163(e) and 1272.

(iv) *Debtor deconsolidation.* The facts are the same as in paragraph (i) of this *Example 2*, except that P sells B's stock to X (rather than S selling B's note to X). The results to S and B are the same as in paragraph (iii) of this *Example 2*.

(v) *Subgroup exception.* The facts are the same as in paragraph (i) of this *Example 2*, except that P owns all of the stock of S, S owns all of the stock of B, and P sells all of the S stock to X, the parent of another consolidated group. Because B and S, members of an intercompany obligation subgroup, cease to be members of the P group in a transaction that does not cause either member to recognize an item with respect to the B note, and such members constitute an intercompany obligation subgroup in the X group, P's sale of S stock is not a triggering transaction under paragraph (g)(3)(i)(B)(*8*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. After the sale, the note held by S has a $100 issue price, a $100 stated redemption price at maturity, and a $100 basis. The results are the same if the S stock is sold to an individual and the S–B affiliated group elects to file a consolidated return for the period beginning on the day after S and B cease to be members of the P group.

(vi) *Section 338 election.* The facts are the same as paragraph (i) of this *Example 2*, except that P sells S's stock to X and a section 338 election is made with respect to the stock sale. Under section 338, S is treated as selling all of its assets to X, including the B note, at the close of the acquisition date. The aggregate deemed sales price (within the meaning of § 1.338–4) allocated to the B note is $70. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued immediately before S's deemed sale to X for $70, the amount realized with respect to the note (the aggregate deemed sales price allocated to the note under § 1.338–6). The results to S and B are the same as in paragraph (ii) of this *Example 2*.

(vii) *Appreciated note.* The facts are the same as in paragraph (i) of this *Example 2*, except that S sells B's note to X for $130 (rather than $70), reflecting a decline in prevailing market interest rates. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*2*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $130 immediately before S's sale to X. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $130 issue price, $100 stated redemption price at maturity, and $130 basis in the hands of S. S is then treated as selling the new note to X for the $130 received by S in the actual transaction. Because S has a basis of $130 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new note held by X is not an intercompany obligation, it has a $130 issue price, a $100 stated redemption price at maturity, and a $130 basis. The treatment of B's $30 of bond issuance premium under the new note is determined under § 1.163–13.

Example 3. Loss or bad debt deduction with respect to intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. On January 1 of year 3, the fair market value of the B note has declined to $60 and S sells the B note to P for property with a fair market value of $60. B is never insolvent within the meaning of section 108(d)(3). The B note is not a security within the meaning of section 165(g)(2).

(ii) *Deemed satisfaction and reissuance.* Because S realizes an amount of loss from the assignment of the B note, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $60 immediately before S's sale to P. As a result of the deemed satisfaction of the note for less than its adjusted issue price ($100), B takes into account $40 of discharge of indebtedness income under § 1.61–12. On a separate entity basis, S's $40 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's $40 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $60 issue price, $100 stated redemption price at maturity, and $60 basis in the hands of S. S is then treated as selling the new note to P for the $60 of property received by S in the actual transaction. Because S has a basis of $60 in the new note, S recognizes no gain or loss from the sale to P. After the sale, the note is an intercompany obligation, it has a $60 issue price and a $100 stated redemption price at maturity, and the

$40 of original issue discount will be taken into account by B and P under sections 163(e) and 1272.

(iii) *Partial bad debt deduction.* The facts are the same as in paragraph (i) of this *Example 3,* except that S claims a $40 partial bad debt deduction under section 166(a)(2) (rather than selling the note to P). Because S realizes a deduction from a transaction comparable to an assignment of the B note, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $60 immediately before section 166(a)(2) applies. The treatment of S's $40 loss and B's $40 of discharge of indebtedness income are the same as in paragraph (ii) of this *Example 3.* After the reissuance, S has a basis of $60 in the new note. Accordingly, the application of section 166(a)(2) does not result in any additional deduction for S. The $40 of original issue discount on the new note will be taken into account by B and S under sections 163(e) and 1272.

(iv) *Insolvent debtor.* The facts are the same as in paragraph (i) of this *Example 3,* except that B is insolvent within the meaning of section 108(d)(3) at the time that S sells the note to P. As explained in paragraph (ii) of this *Example 3,* the transaction is a triggering transaction and the B note is treated as satisfied and reissued for its fair market value of $60 immediately before S's sale to P. On a separate entity basis, S's $40 loss would be capital, B's $40 income would be excluded from gross income under section 108(a), and B would reduce attributes under section 108(b) or section 1017 (see also § 1.1502–28). However, under paragraph (g)(4)(i)(C) of this section, section 108(a) does not apply to characterize B's income as excluded from gross income. Accordingly, the attributes of S's loss and B's income are redetermined in the same manner as in paragraph (ii) of this *Example 3.*

Example 4. Intercompany nonrecognition transactions. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is $130, reflecting a decline in prevailing market interest rates. On January 1 of year 3, S transfers the note and other assets to a newly formed corporation, Newco, for all of Newco's stock in an exchange to which section 351 applies. The aggregate adjusted bases of property transferred does not exceed the fair market value of such property immediately after the transfer.

(ii) *No deemed satisfaction and reissuance.* Because the assignment of the B note is an exchange to which section 351 applies and S recognizes no gain or loss, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*1*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

(iii) *Receipt of other property.* The facts are the same as in paragraph (i) of this *Example 4*, except that the other assets transferred to Newco have a basis of $100 and a fair market value of $260, and S receives, in addition to Newco stock, $15 of cash. Because S would recognize $15 of gain under section 351(b), the assignment of the B note is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of $130 immediately before the transfer to Newco. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a $130 issue price, $100 stated redemption price at maturity, and $130 basis in the hands of S. S is then treated as transferring the new note to Newco for the Newco stock and cash received by S in the actual transaction. Because S has a basis of $130 in the new B note, S recognizes no gain or loss with respect to the transfer of the note in the section 351 exchange, and S recognizes $10 of gain with respect to the transfer of the other assets under section 351(b). After the transfer, the note has a $130 issue price and a $100 stated redemption price at maturity. The treatment of B's $30 of bond issuance premium under the new note is determined under § 1.163–13.

(iv) *Intercompany obligation transferred in section 332 transaction.* The facts are the same as in paragraph (i) of this *Example 4,* except that S transfers the B note to P in complete liquidation under section 332. Because the transaction is an exchange to which section 332 applies, and neither S nor B recognize gain or loss, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*1*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

Example 5. Assumption of intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. The note is fully recourse and is incurred for use in Business Z. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is $110 reflecting a decline in prevailing market interest rates. Business Z has a fair market value of $95. On January 1 of year 3, B transfers all of the assets of Business Z and $15 of cash to M in exchange for the assumption by M of all of B's obligations under the note. The terms and conditions of the note are not modified in connection with the sales transaction, and no amount of income, gain, loss, or deduction is recognized by S, B, or M with respect to the note.

(ii) *No deemed satisfaction and reissuance.* Because all of B's obligations under the B note are assumed by M in connection with the sale of the Business Z assets, the assignment of B's obligations under the note is not a triggering transaction under paragraph (g)(3)(i)(B)(*2*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

Example 6. Extinguishment of intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. The note is a security within the meaning of section 351(d)(2). As of January 1 of year 3, B has fully performed its obligations, but the fair market value of the B note is $130, reflecting a decline in prevailing market interest rates, and S transfers the note to B in exchange for $130 of B stock in a transaction to which section 351 applies.

(ii) *No deemed satisfaction and reissuance.* As a result of the satisfaction of the note for more than its adjusted issue price, B takes into account $30 of repurchase premium under § 1.163–7(c). Although the transfer of the B note is a transaction to which section 351 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to section 351(a), and therefore, S has a $30 gain under section 1001. Because the note is extinguished in a transaction in which the adjusted issue price of the note is equal to the creditor's basis in the note, and the debtor's and creditor's items offset in amount, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*5*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. On a separate entity basis, S's $30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. Under paragraph (g)(4)(i)(D) of this section, section 108(e)(7) does not apply upon the extinguishment of the B note, and therefore, the B stock received by S in the exchange will not be treated as section 1245 property.

Example 7. Exchange of intercompany obligations. (i) *Facts.* On January 1 of year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 20. As of January 1 of year 3, B has fully performed its obligations and, pursuant to a recapitalization to which section 368(a)(1)(E) applies, B issues a new note to S in exchange for the original B note. The new B note has an issue price, stated redemption price at maturity, and stated principal amount of $100, but contains terms that differ sufficiently from the terms of the original B note to cause a realization event under § 1.1001–3. The original B note and the new B note are both securities (within the meaning of section 354(a)(1)).

(ii) *No deemed satisfaction and reissuance.* Because the original B note is extinguished in exchange for a newly issued B note and the issue price of the new B note is equal to both the adjusted issue price of the original B note and S's basis in the original B note, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(*6*) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. B has neither income from discharge of indebtedness under section 108(e)(10) nor a deduction for repurchase premium under § 1.163–7(c). Although the exchange of the original B note for the new B note is a transaction to which section 354 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to section 354. Under section 1001, S has no gain or loss from the exchange of notes.

Example 8. Material tax benefit rule. (i) *Facts.* T is a member with a material loss from a separate return limitation year (SRLY). S holds a materially appreciated B note which it transfers to T as part of an exchange which otherwise qualifies for nonrecognition treatment under section 351.

(ii) *Deemed satisfaction and reissuance.* Under paragraph (g)(3)(i)(B)(*1*) of this section, absent the application of the material tax benefit rule of paragraph (g)(3)(i)(C) of this section, the assignment of the B note would not be a triggering transaction. However, because at the time of the assignment, it is reasonably foreseeable that the shifting of the built-in income or gain from the obligation will secure a material tax benefit that the group or its members would not otherwise enjoy, under paragraph (g)(3)(i)(C) of this section, the assignment of the B note is a triggering transaction to which paragraph (g)(3)(ii) of this section applies. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value, immediately before S's transfer to T. As a result of the deemed satisfaction of the note for more than its adjusted issue price, S takes into account gain and B has a corresponding repurchase premium deduction. B is also treated as reissuing, immediately after the deemed satisfaction, a new note to S with an issue price and basis equal to its fair market value. S is then treated as transferring the new note to T as part of the section 351 exchange. Because T will have a fair market value basis in the reissued B note immediately after the exchange, T's intercompany item from the subsequent retirement of the B note will not reflect any of S's built-in gain (and the amount of SRLY loss that may be absorbed by such item will be limited to any appreciation in the B note accruing after the exchange).

(iii) *No material tax benefit.* The facts are the same as in paragraph (i) of this *Example 8*, except that S has a SRLY loss that exceeds, and will expire prior to, that of T. Further, it is anticipated that S and T will each generate similar amounts of income for the foreseeable future, and there is no plan or intention to sell the stock of either member. Because the built-in income or gain from the B note could have been used to facilitate the absorption of S's SRLY loss (rather than an equal amount of T's SRLY loss), the group and its members have not secured a material tax benefit from the assignment that it would not have otherwise enjoyed. Accordingly, the assignment is not subject to the material tax benefit rule of paragraph (g)(3)(i)(C) of this section, and the B note is not deemed satisfied and reissued under paragraph (g)(3)(ii) of this section.

Example 9. Issuance at off-market rate of interest. (i) *Facts.* T is a member with a material loss from a separate return limitation year (SRLY). T's sole shareholder, P, borrows an amount from T in return for a P note that provides for a materially above market rate of interest. As a result, the P note will generate additional interest income to T over the term of the note which will facilitate the absorption of T's SRLY loss each year and will result in a material tax benefit.

(ii) *Reasonably foreseeable.* Because at the time of the issuance, it is reasonably foreseeable that the shifting of interest income from the off-market obligation will secure a material tax benefit that the group or its members would not otherwise enjoy, under paragraph (g)(4)(iii) of this section, the intercompany obligation is treated, for all Federal income tax purposes, as originally issued for its fair market value so T is treated as purchasing the note at a premium. The difference between the amount loaned and the fair market value of the obligation is treated as transferred from P to T as a capital contribution at the time the note is issued. Throughout the term of the note, T takes into account interest income and bond premium and P takes into account interest deduction and bond issuance premium under generally applicable Internal Revenue Code sections. Because paragraph (g)(4)(iii) of this section applies, no adjustment is made under section 482.

Example 10. Nonintercompany obligation becomes intercompany obligation. (i) *Facts.* On January 1 of year 1, B borrows $100 from X in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is $70, reflecting an increase in prevailing market interest rates. On January 1 of year 3, P buys all of X's stock. B is solvent within the meaning of section 108(d)(3).

(ii) *Deemed satisfaction and reissuance.* Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for $70 (determined under the principles of § 1.108–2(f)(2)) immediately after it becomes an intercompany obligation. Both X's $30 capital loss (under section 1271(a)(1)) and B's $30 of discharge of indebtedness income (under § 1.61–12) are taken into account in determining consolidated taxable income for year 3. Under paragraph (g)(6)(i)(B) of this section, the attributes of items resulting from the satisfaction are determined on a separate entity basis. But see section 382 and § 1.1502–15 (as appropriate). B is also treated as reissuing a new note to X. The new note is an intercompany obligation, it has a $70 issue price and $100 stated redemption price at maturity, and the $30 of original issue discount will be taken into account by B and X in the same manner as provided in paragraph (iii) of *Example 1* of this paragraph (g)(7).

(iii) *Amortization of repurchase premium.* The facts are the same as in paragraph (i) of this *Example 10,* except that on January 1 of year 3, the B note has a fair market value of $130 and rather than purchasing the X stock, S purchases the B note from X by issuing its own note. The S note has an issue price, stated redemption price at maturity, stated principal amount, and a fair market value of $130. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for $130 (determined under the principles of § 1.108–2(f)(1)) immediately after it becomes an intercompany obligation. As a result of the deemed satisfaction of the note, S has no gain or loss and B has $30 of repurchase premium. Under paragraph (g)(6)(iii) of this section, B's $30 of repurchase premium from the deemed satisfaction is amortized by B over the term of the newly issued S note in the same manner as if it were original issue discount and the newly issued S note had been issued directly by B. B is also treated as reissuing a new note to S. The new note is an intercompany obligation, it has a $130 issue price and $100 stated redemption price at maturity, and the treatment of B's $30 of bond issuance premium under the new B note is determined under § 1.163–13.

(iv) *Election to file consolidated returns.* Assume instead that B borrows $100 from S during year 1, but the P group does not file consolidated returns until year 3. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied and reissued as a new note immediately after the note becomes an intercompany obligation. The satisfaction and reissuance are deemed to occur on January 1 of year 3, for the fair market value of the obligation (determined under the principles of § 1.108–2(f)(2)) at that time.

Example 11. Notional principal contracts. (i) *Facts.* On April 1 of year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined by reference to LIBOR on the day each payment is due, multiplied by a $1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in year 2, in an amount equal to 8 percent multiplied by the same notional principal amount. LIBOR is 7.80 percent on April 1 of year 2, and therefore, M2 owes $2 to M1.

(ii) *Matching rule.* Under § 1.446–3(d), the net income (or net deduction) from a notional principal contract for a taxable year is included in (or deducted from) gross income. Under § 1.446–3(e), the ratable daily portion of M2's obligation to M1 as of December 31 of year 1 is $1.50 ($2 multiplied by 275/365). Under the matching rule, M1's net income for year 1 of $1.50 is taken into account to reflect the difference between M2's net deduction of $1.50 taken into account and the $0 recomputed net deduction. Similarly, the $.50 balance of the $2 of net periodic payments made on April 1 of year 2 is taken into account for year 2 in M1's and M2's net income and net deduction from the contract.

In addition, the attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. (Although M1 is the selling member with respect to the payment on April 1 of year 2, it might be the buying member in a subsequent period if it owes the net payment.)

(iii) *Dealer.* The facts are the same as in paragraph (i) of this *Example 11,* except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to fair market value at year-end. Assume that under section 475, M2's loss from marking to fair market value the contract with M1 is $10. Because M2 realizes an amount of loss from the mark to fair market value of the contract, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(1) of this section. Under paragraph (g)(3)(ii) of this section, M2 is treated as making a $10 payment to M1 to terminate the contract immediately before a new contract is treated as reissued with an up-front payment by M1 to M2 of $10. M1's $10 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under § 1.446–3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Under § 1.446–3(f), the deemed $10 up-front payment by M1 to M2 in connection with the issuance of a new contract is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the $1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment from M2 might be ordinary or capital). Under paragraph (g)(3)(ii)(A) of this section, section 475 does not apply to mark the notional principal contract to fair market value after its deemed satisfaction and reissuance.

(8) *Effective/applicability date.* The rules of this paragraph (g) apply to transactions involving intercompany obligations occurring in consolidated return years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

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Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

[FR Doc. E7–19134 Filed 9–27–07; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

42 CFR Parts 406, 407, and 408

[CMS–4129–P]

RIN 0938–A077

Medicare Program; Special Enrollment Period and Medicare Premium Changes

AGENCY: Centers for Medicare & Medicaid Services (CMS), HHS.

ACTION: Proposed rule.

SUMMARY: This proposed rule would provide a special enrollment period (SEP) for Medicare Part B and premium Part A for certain individuals who are sponsored by prescribed organizations as volunteers outside of the United States and who have health insurance that covers them while outside the United States. Under the SEP provision, qualifying volunteers can delay enrollment in Part B and premium Part A, or terminate such coverage, for the period of service outside of the United States and reenroll without incurring a premium surcharge for late enrollment or reenrollment.

This proposed rule would also codify provisions that require certain beneficiaries to pay an income-related monthly adjustment amount (IRMAA) in addition to the standard Medicare Part B premium, plus any applicable increase for late enrollment or reenrollment. The income-related monthly adjustment amount is to be paid by beneficiaries who have a modified adjusted gross income that exceeds certain threshold amounts. It also represents the amount of decreases in Medicare Part B premium subsidy, that is, the amount of the Federal government's contribution to the Federal Supplementary Medicare Insurance (SMI) Trust Fund.

DATES: To be assured consideration, comments must be received at one of the addresses provided below, no later than 5 p.m. on November 27, 2007.

ADDRESSES: In commenting, please refer to file code CMS–4129–P. Because of staff and resource limitations, we cannot accept comments by facsimile (FAX) transmission.

You may submit comments in one of four ways (no duplicates, please):

1. *Electronically.* You may submit electronic comments on specific issues in this regulation to *http://www.cms.hhs.gov/eRulemaking.* Click on the link ''Submit electronic comments on CMS regulations with an open comment period.'' (Attachments should be in Microsoft Word, WordPerfect, or Excel; however, we prefer Microsoft Word.)

2. *By regular mail.* You may mail written comments (one original and two copies) to the following address ONLY: Centers for Medicare & Medicaid Services, Department of Health and Human Services, Attention: CMS–4129–P, P.O. Box 8017, Baltimore, MD 21244–8017.

Please allow sufficient time for mailed comments to be received before the close of the comment period.

3. *By express or overnight mail.* You may send written comments (one original and two copies) to the following address ONLY: Centers for Medicare & Medicaid Services, Department of Health and Human Services, Attention: CMS–4129–P, Mail Stop C4–26–05, 7500 Security Boulevard, Baltimore, MD 21244–1850.

4. *By hand or courier.* If you prefer, you may deliver (by hand or courier) your written comments (one original and two copies) before the close of the comment period to one of the following addresses. If you intend to deliver your comments to the Baltimore address, please call telephone number (410) 786–7195 in advance to schedule your arrival with one of our staff members. Room 445–G, Hubert H. Humphrey Building, 200 Independence Avenue, SW., Washington, DC 20201; or 7500 Security Boulevard, Baltimore, MD 21244–1850.

(Because access to the interior of the HHH Building is not readily available to persons without Federal government identification, commenters are encouraged to leave their comments in the CMS drop slots located in the main lobby of the building. A stamp-in clock is available for persons wishing to retain a proof of filing by stamping in and retaining an extra copy of the comments being filed.)

Comments mailed to the addresses indicated as appropriate for hand or courier delivery may be delayed and received after the comment period.

Submission of comments on paperwork requirements. You may