

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106221-98]

RIN 1545-AW53

Guidance Under Section 1032 Relating to the Treatment of a Disposition by One Corporation of the Stock of Another Corporation in a Taxable Transaction**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of a disposition by a corporation (the acquiring corporation) of the stock of another corporation (the issuing corporation) in a taxable transaction. The proposed regulations interpret section 1032 of the Internal Revenue Code. The proposed regulations affect corporations and their subsidiaries.

DATES: Written comments must be received by December 22, 1998. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Thursday, January 7, 1999 must be received by Thursday, December 17, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-106221-98), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG-106221-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lee A. Dean, (202) 622-7550; concerning submissions and the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1032(a) provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

Before the enactment of section 1032 in 1954, Treasury regulations provided that "where a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another." (Treas. Reg. 111, § 29.22(a)-15 (1934)).

As applied, this regulation resulted in the recognition of gain or loss on the disposition by a corporation of its treasury stock, even though the corporation would not have recognized gain or loss on the disposition of newly issued shares. See, e.g., *Firestone Tire & Rubber Co. v. Commissioner*, 2 T.C. 827 (1943). This disparity of treatment gave rise to tax avoidance possibilities. A corporation expecting a gain upon disposition of treasury shares might avoid such gain by canceling its treasury shares and issuing new stock, whereas a corporation might produce a fictitious loss by purchasing its own shares and reselling them at a lower price.

Congress enacted section 1032(a) in 1954 to eliminate this potential disparity between the tax treatment of a disposition by a corporation of its treasury stock and a disposition of newly issued stock. H.R. No. 1337, 83d Cong., 2d Sess. 268 (1954).

Rev. Rul. 74-503 (1974-2 C.B. 117) considers the tax consequences of a parent corporation's transfer to its subsidiary of its own treasury stock in a transaction to which section 351 applies. The ruling states that "[t]he transfer of [parent] stock was not for the purpose of enabling [the subsidiary corporation] to acquire property by the use of such stock." Rev. Rul. 74-503 holds that, since the basis of previously unissued parent stock in the hands of the parent corporation is zero, the basis of the parent corporation's treasury stock in the hands of the parent corporation is also zero. Accordingly, under the transferred basis rule of section 362(a), the subsidiary corporation's basis of the treasury stock of the parent corporation is also zero (the zero basis result).

Section 1.1032-2(b), applicable to certain triangular reorganizations occurring on or after December 23, 1994,

eliminates gain recognition in certain cases when an acquiring corporation (S) acquires property or stock of another corporation (T) in exchange for stock of the corporation (P) in control of S. Section 1.1032-2(b) provides that, "For purposes of § 1.1032-1(a), in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in § 1.358-6(b)), P stock provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization is treated as a disposition by P of its own stock for T's assets or stock, as applicable." Section 1.1032-2(c) provides that S must recognize gain or loss on its exchange of P stock if S did not receive the P stock pursuant to the plan of reorganization.

Section 1.1502-13(f)(6)(ii), initially published as temporary regulations applicable to transactions occurring on or after July 12, 1995 (TD 8598, 1995-2 C.B. 188), eliminates gain recognition under certain conditions on a member's disposition of the stock of its common parent. If the requirements of that section are satisfied, § 1.1502-13(f)(6)(ii) provides that "If a member, M, would otherwise recognize gain on a qualified disposition of P stock, then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members)." Among other requirements, the member must, pursuant to a plan, transfer the stock "immediately to a nonmember that is not related." See § 1.1502-13(f)(6)(ii)(B). The preamble to the temporary regulations explains that the gain relief provisions "prevent taxpayers from being subject to inappropriate taxation on gains in certain transactions." (TD 8598, 1995-2 C.B. 188, 189.)

Section 83 provides rules for property, including parent's stock, transferred in connection with the performance of services. Section 83(h) provides, in part, that "there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included * * * in the gross income of the person who performed such services." Section 1.83-6(b) provides that "[e]xcept as provided in section 1032, at the time of the transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property." Section 1.83-6(d) provides

that, "[i]f a shareholder of a corporation transfers property to an employee of such corporation * * * in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee. * * *."

Rev. Rul. 80-76 (1980-1 C.B. 15) addresses the use of a parent corporation's stock as compensation to an employee of a subsidiary corporation. Under the facts, A, a shareholder of P, transfers P stock directly to B, an employee of S. The ruling holds in part that, "because section 83 applies to the transfer of P stock to B, S does not recognize gain or loss on the transfer of the P stock."

Explanation of Provisions

Some of the concerns that ultimately led to the enactment of section 1032 are present where a subsidiary corporation holds the stock of a parent corporation. For example, a parent corporation could place treasury stock in a subsidiary corporation in order to attempt to recognize losses if the price of the parent corporation stock goes down, or could sell shares directly if the price rises. See Rev. Rul. 74-503 (1974-2 C.B. 117). The zero basis result limits such planning opportunities.

These tax avoidance possibilities are not present, however, in transactions where one corporation transfers its own stock to another corporation pursuant to a plan by which the second corporation immediately transfers the stock of the first corporation to acquire money or other property. The risk of selective loss recognition does not arise where the stock of the parent corporation is used immediately by the subsidiary corporation to acquire money or other property and therefore does not have sufficient time to depreciate in value. This concept is reflected in Rev. Rul. 74-503, which provides a factual carve-out for transfers of parent corporation stock made for the purpose of enabling a subsidiary corporation to acquire property. Also, the IRS and the Treasury have not applied the zero basis result in such integrated transactions, regardless of whether such a disposition of stock is part of a tax-free reorganization or is part of a taxable acquisition. See §§ 1.1502-13(f)(6)(ii) and 1.1032-2(b). These proposed regulations provide that no gain or loss is recognized in certain taxable transactions where one corporation immediately disposes of the stock of another corporation pursuant to a plan to acquire money or other

property. The IRS and Treasury believe that, in such transactions, the nonapplicability of the zero basis result avoids inappropriate gain recognition and is consistent with the purposes of section 1032. No inference is intended regarding the applicability of the zero basis result to transactions outside of the scope of these proposed regulations.

If the conditions of these proposed regulations are satisfied, no gain or loss is recognized on the disposition of the stock of one corporation (the issuing corporation) by another corporation (the acquiring corporation). The proposed regulations apply if, pursuant to a plan to acquire money or other property, (1) the acquiring corporation acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring corporation would be determined with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a); (2) the acquiring corporation immediately transfers the stock of the issuing corporation to acquire money or other property; and (3) no party receiving stock of the issuing corporation from the acquiring corporation receives a substituted basis in the stock of the issuing corporation within the meaning of section 7701(a)(42). For purposes of this section, "property" includes services. See § 1.1032-1.

Mechanics of Proposed Regulations

These proposed regulations adopt the cash purchase model used in § 1.1502-13(f)(6)(ii) to provide relief from gain.

In transactions to which the proposed regulations apply, immediately before the disposition of the issuing corporation's stock, the acquiring corporation is treated as purchasing the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring corporation by the issuing corporation (or, if necessary, through intermediate corporations).

As a result of this deemed cash purchase of stock, the acquiring corporation will have a fair market value basis in the issuing corporation's stock pursuant to section 1012, and the issuing corporation will increase its basis in the stock of the acquiring corporation (and, if necessary, the stock basis of intermediate corporations) by that amount. See, e.g., section 358.

No inference is intended regarding whether circular cash flows would be respected apart from this regulation. Similarly, no inference is intended with

respect to other methods of avoiding gain on the acquiring corporation's use of the issuing corporation's stock.

A cross-reference in § 1.83-6(d) to the proposed regulations clarifies that the mechanics of the proposed regulations—rather than the mechanics of § 1.83-6(d)—apply to a corporate shareholder's transfer of its own stock to any person in consideration of services performed for another corporation where the conditions of these proposed regulations are satisfied.

The cash purchase model of these proposed regulations preserves the acquiring corporation's deduction under section 162 for the use of the issuing corporation's stock to compensate the acquiring corporation's employees. In addition, as in Rev. Rul. 80-76, the cash purchase model of these proposed regulations provides that the acquiring corporation will not recognize gain or loss on the transfer of the stock of the issuing corporation. The proposed regulations provide that the cash purchase model is applicable only when the acquiring corporation immediately transfers the stock of the issuing corporation to acquire money or other property. The IRS and the Treasury believe that these proposed regulations address the same issues as in Rev. Rul. 80-76 and, when issued in final form, will render Rev. Rul. 80-76 obsolete.

Stock Options

Section 1032(a), in conjunction with the rules governing the taxation of options, also operates to prevent selective loss recognition in the case where a corporation issues options to buy or sell its own stock. See Deficit Reduction Act of 1984, H.R. Rep. No. 432, 98th Cong., 2d. Sess. pt. 2 1196 (1984) (expanding section 1032(a) to provide that a corporation does not recognize gain or loss with respect to any lapse or acquisition of an option to buy or sell its stock, including treasury stock). As in the case of a subsidiary corporation's dealings in parent corporation stock, however, section 1032 may not always prevent selective loss recognition where a subsidiary corporation deals in options on parent corporation stock. Again, the zero basis result serves to limit such planning opportunities.

The Treasury and the IRS have determined that the concerns underlying section 1032 are not present where the issuing corporation transfers options on its own stock to the acquiring corporation pursuant to a plan by which the acquiring corporation immediately transfers those options to acquire money or other property. Accordingly, these proposed regulations

apply to an option issued by an issuing corporation to buy or sell its own stock in the same manner as they apply to stock of an issuing corporation.

Amendment to § 1.1032-2

The preamble to the final regulations under § 1.1032-2 states that the tax treatment of a disposition by the acquiring corporation (S) of stock options of the corporation (P) in control of S was beyond the scope of the project. (Preamble to Final Regulations under sections 358, 1032 and 1502 [TD 8648, 1996-1 C.B. 37, 39].) The IRS and the Treasury believe that the tax treatment of stock options of the issuing corporation in these triangular reorganizations also should be addressed under section 1032. Accordingly, these proposed regulations amend § 1.1032-2 to provide that § 1.1032-2 shall apply to an option to buy or sell P stock issued by P in the same manner as that section applies to the stock of P.

Proposed Effective Date

The regulations are proposed to be effective on the date that final regulations are published 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 EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, January 7, 1999 beginning at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue

Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must request to speak, and submit an outline of topics to be discussed and the time to be devoted to each topic by Thursday, December 17, 1998.

A period of ten minutes will be allocated to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Lee A. Dean of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.83-6 is amended by adding two sentences to the end of paragraph (d)(1) to read as follows:

§ 1.83-6 Deduction by employer.

* * * * *

(d)(1) * * * For special rules that may apply to a corporate shareholder's transfer of its own stock to any person in consideration of services performed for another corporation, see § 1.1032-3. The preceding sentence applies to transfers of stock occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

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Par. 3. Section 1.1032-2 is amended by:

1. Revising paragraph (e);
2. Adding paragraph (f).

The addition and revision read as follows:

§ 1.1032-2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

* * * * *

(e) *Stock options.* The rules of this section shall apply to an option to buy or sell P stock issued by P in the same manner as the rules of this section apply to P stock.

(f) *Effective dates.* This section applies to triangular reorganizations occurring on or after December 23, 1994. Paragraph (e) applies to transfers of stock options occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.1032-3 is added to read as follows:

§ 1.1032-3 Disposition of stock or stock options in certain transactions not qualifying under any other nonrecognition provision.

(a) *Scope.* This section provides rules for certain transactions in which one corporation (the acquiring corporation) acquires money or other property (as defined in § 1.1032-1) in exchange, in whole or in part, for stock of another corporation (the issuing corporation).

(b) *General rule.* In a transaction to which this section applies, no gain or loss is recognized on the disposition of the issuing corporation's stock by the acquiring corporation. The transaction is treated as if, immediately before the acquiring corporation disposes of the stock of the issuing corporation, the acquiring corporation purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring corporation by the issuing corporation (or, if necessary, through intermediate corporations).

(c) *Applicability.* The rules of this section apply only if, pursuant to a plan to acquire money or other property—

(1) The acquiring corporation acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring corporation would be determined with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a);

(2) The acquiring corporation immediately transfers the stock of the issuing corporation to acquire money or other property; and

(3) No party receiving stock of the issuing corporation from the acquiring corporation receives a substituted basis in the stock of the issuing corporation within the meaning of section 7701(a)(42).

(d) *Stock options.* The rules of this section shall apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules of this section apply to the stock of an issuing corporation.

(e) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) *X*, a corporation, owns all of the stock of *Y* corporation. *Y* reaches an agreement with *A*, an individual, to acquire a truck from *A* in exchange for 10 shares of *X* stock with a fair market value of \$100. To effectuate *Y*'s agreement with *A*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *A* to acquire the truck.

(ii) In this *Example 1*, no gain or loss is recognized on the disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*.

Example 2. (i) Assume the same facts as *Example 1*, except that, rather than *X* stock, *X* transfers an option with a fair market value of \$100 to buy *X* stock.

(ii) In this *Example 2*, no gain or loss is recognized on the disposition of the *X* stock option by *Y*. Immediately before *Y*'s disposition of the *X* stock option, *Y* is treated as purchasing the *X* stock option from *X* for \$100 of cash contributed to *Y* by *X*.

Example 3. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *A*, an individual, is an employee of *Y*. Pursuant to an agreement between *X* and *Y* to compensate *A* for services provided to *Y*, *X* transfers to *A* 10 shares of *X* stock with a fair market value of \$100. Under § 1.83-6(d), but for this section, the transfer of *X* stock by *X* to *A* would be treated as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a transfer of the *X* stock by *Y* to *A*. But for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 3*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*.

Example 4. (i) *X*, a corporation, issues 10 shares of *X* stock subject to a substantial risk of forfeiture to compensate *Y*'s employee, *A*, for services. *A* does not have an election under section 83(b) in effect with respect to the *X* stock. *X* retains a reversionary interest in the *X* stock in the event that *A* forfeits the right to the stock. At the time the stock vests, the 10 shares of *X* stock have a fair market value of \$100. Under § 1.83-6(d), but for this section, the transfer of the *X* stock by *X* to *A* would be treated, at the time the stock vests, as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a disposition of the *X* stock by *Y* to *A*. The basis of the *X* stock in the hands of *Y*, but for this section, would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 4*, no gain or loss is recognized on the deemed disposition of *X* stock by *Y* when the stock vests. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing *X*'s stock from *X* for \$100 of cash contributed to *Y* by *X*.

Example 5. (i) Assume the same facts as in *Example 4*, except that *Y* (rather than *X*) retains a reversionary interest in the *X* stock in the event that *A* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests.

(ii) This section does not apply to *Y*'s deemed disposition of the *X* shares. For the tax consequences to *Y* on the deemed disposition of the *X* stock, see § 1.83-6(b).

(f) *Effective date.* This section applies to transfers of stock or stock options of the issuing corporation occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Michael P. Dolan,

Deputy Commissioner of Internal Revenue.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[REG-209769-95]

RIN 1545-AT56

Exception From Supplemental Annuity Tax on Railroad Employers

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance to employers covered by the Railroad Retirement Tax Act. The Railroad Retirement Tax Act imposes a supplemental tax on those employers, at a rate determined by the Railroad Retirement Board, to fund the Railroad Retirement Board's supplemental annuity benefit. These proposed regulations provide rules for applying the exception from the supplemental tax with respect to employees covered by a supplemental pension plan established pursuant to a collective bargaining agreement and for applying a related excise tax with respect to employees for whom the exception applies. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by December 22, 1998. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for January 20, 1999, must be received by December 30, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209769-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station,

Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG-209769-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at <http://www.irs.ustreas.gov/prod/taxregs/comments.html>. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations, Linda S. F. Marshall, (202) 622-6030; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Employment Tax Regulations (26 CFR Part 31) under section 3221(d). These proposed regulations provide guidance regarding the section 3221(d) exception from the tax imposed under section 3221(c) with respect to employees covered by a supplemental pension plan of the employer established pursuant to an agreement reached through collective bargaining.

Under the Railroad Retirement Act of 1974, as amended (RRA), an employee of a railroad employer generally is entitled to receive a supplemental annuity paid by the Railroad Retirement Board (RRB) at retirement. An employee is entitled to receive a supplemental annuity only if the employee has performed at least 25 years of service with the railroad industry, including service with the railroad industry before October 1, 1981. The monthly amount of the supplemental annuity ranges from \$23 to \$43, based on the employee's number of years of service. See 45 U.S.C. 231b(e). Under section 2(h)(2) of the RRA, an employee's supplemental annuity is reduced by the amount of payments received by the employee from any plan determined by the RRB to be a supplemental pension plan of the employer, to the extent those payments are derived from employer contributions.

Section 3221(c) imposes a tax on each railroad employer to fund the supplemental annuity benefits payable by the Railroad Retirement Board. The tax imposed under section 3221(c) is