

and a continuity of business enterprise are not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) (E reorganization) or section 368(a)(1)(F) (F reorganization). The notice also proposed amending § 1.368-2 to include rules regarding the requirements for a transaction to qualify as an F reorganization and regarding the effects of an F reorganization.

The IRS and Treasury Department have received oral comments urging that the rule providing that the continuity of interest and continuity of business enterprise requirements do not apply to E and F reorganizations be finalized quickly. For the reasons expressed in the preamble to the proposed regulations, this Treasury decision adopts that rule for transactions on or after February 25, 2005. The IRS and Treasury Department continue to study the other issues addressed in the notice of proposed rulemaking, and welcomes further comment on those issues.

#### Effect on Other Documents

The following publications are obsolete as of February 25, 2005:

Rev. Rul. 69-516 (1969-2 C.B. 56).  
 Rev. Rul. 77-415 (1977-2 C.B. 311).  
 Rev. Rul. 77-479 (1977-2 C.B. 119).  
 Rev. Rul. 82-34 (1982-1 C.B. 59).

#### Special Analyses

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

#### Drafting Information

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

#### List of Subjects 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Adoption of Amendment to the Regulations

■ Accordingly, 26 CFR part 1 is 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 1.368-1(b) is amended by adding a sentence after the seventh sentence to read as follows:

#### § 1.368-1 Purpose and scope of exception of reorganization exchanges.

\* \* \* \* \*

(b) *Purpose.* \* \* \* Notwithstanding the requirements of this paragraph (b), for transactions occurring on or after February 25, 2005, a continuity of the business enterprise and a continuity of interest are not required for the transaction to qualify as a reorganization under section 368(a)(1)(E) or (F). \* \* \*

\* \* \* \* \*

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

Approved: February 14, 2005.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury.*

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#### DEPARTMENT OF THE TREASURY

#### Internal Revenue Service

#### 26 CFR Parts 1 and 301

[TD 9183]

**RIN 1545-BA59**

#### Modification of Check the Box

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulation.

**SUMMARY:** This document contains final regulations that clarify that qualified REIT subsidiaries, qualified subchapter S subsidiaries, and single owner eligible entities that are disregarded as entities separate from their owners are treated as separate entities for purposes of any Federal tax liability for which the entity is liable. These regulations affect disregarded entities that are liable for Federal taxes with respect to tax periods during which they were not disregarded or because they are successors or transferees of taxable entities.

**DATES:** *Effective Date:* These regulations are effective April 1, 2004.

*Applicability Dates:* For dates of applicability, see §§ 1.856-9(c), 1.1361-4(a)(6)(iii), and 301.7701-2(e).

#### FOR FURTHER INFORMATION CONTACT:

Martin Schäffer, (202) 622-3070 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

#### Background

This document contains amendments to 26 CFR parts 1 and 301. The amendments to 26 CFR part 1 are under sections 856 and 1361 of the Internal Revenue Code (Code). Section 856(i) was added by the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085). Section 1361(b)(3) was added by the Small Business Job Protection Act of 1996 (Pub. L. 104-188, 110 Stat. 1755). The amendments to 26 CFR part 301 are to § 301.7701-2, first promulgated by TD 8697, 61 FR 66584 (December 18, 1996). On April 1, 2004, a notice of proposed rulemaking (REG-106681-02) relating to the taxation of disregarded entities was published in the **Federal Register** (69 FR 17117). A notice of correction was published in the **Federal Register** (69 FR 22463) on April 26, 2004. No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested, and accordingly, no hearing was held. This Treasury decision adopts the language of the proposed regulations with only minor clarifying changes.

#### Special Analyses

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

#### Drafting Information

The principal author of these regulations is James M. Gergurich of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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

Income taxes, Reporting and recordkeeping requirements.

**26 CFR Part 301**

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

■ Accordingly, 26 CFR parts 1 and 301 are amended as follows:

**PART 1—INCOME TAX**

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

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

■ **Par. 2.** Section 1.856–9 is added to read as follows:

**§ 1.856–9 Treatment of certain qualified REIT subsidiaries.**

(a) *In general.* A qualified REIT subsidiary, even though it is otherwise not treated as a corporation separate from the REIT, is treated as a separate corporation for purposes of:

(1) Federal tax liabilities of the qualified REIT subsidiary with respect to any taxable period for which the qualified REIT subsidiary was treated as a separate corporation.

(2) Federal tax liabilities of any other entity for which the qualified REIT subsidiary is liable.

(3) Refunds or credits of Federal tax.

(b) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

*Example 1.* X, a calendar year taxpayer, is a domestic corporation 100 percent of the stock of which is acquired by Y, a real estate investment trust, in 2002. X was not a member of a consolidated group at any time during its taxable year ending in December 2001. Consequently, X is treated as a qualified REIT subsidiary under the provisions of section 856(i) for 2002 and later periods. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2001 taxable year. Because X was treated as a separate corporation for its 2001 taxable year, X is the proper party to sign the consent to extend the period of limitations.

*Example 2.* The facts are the same as in *Example 1*, except that upon Y's acquisition of X, Y and X jointly elect under section 856(l) to treat X as a taxable REIT subsidiary of Y. In 2003, Y and X jointly revoke that election. Consequently, X is treated as a qualified REIT subsidiary under the provisions of section 856(i) for 2003 and later periods. In 2004, the IRS determines that X miscalculated and underreported its income

tax liability for 2001. Because X was treated as a separate corporation for its 2001 taxable year, the deficiency may be assessed against X and, in the event that X fails to pay the liability after notice and demand, a general tax lien will arise against all of X's property and rights to property.

*Example 3.* X is a qualified REIT subsidiary of Y under the provisions of section 856(i). In 2001, Z, a domestic corporation that reports its taxes on a calendar year basis, merges into X in a state law merger. Z was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, X is the successor to Z and is liable for all of Z's debts. In 2004, the IRS seeks to extend the period of limitations on assessment for Z's 2000 taxable year. Because X is the successor to Z and is liable for Z's 2000 taxes that remain unpaid, X is the proper party to sign the consent to extend the period of limitations.

(c) *Effective date.* This section applies on or after April 1, 2004.

■ **Par. 3.** Section 1.1361–4 is amended as follows:

■ 1. In paragraph (a)(1) introductory text, the first sentence is amended by removing the language “paragraph (a)(3)” and adding “paragraphs (a)(3) and (a)(6)” in its place.

■ 2. Paragraph (a)(6) is added.

The additions read as follows:

**§ 1.1361–4 Effect of QSub election.**

(a) \* \* \*

(6) *Treatment of certain QSubs—(i) In general.* A QSub, even though it is generally not treated as a corporation separate from the S corporation, is treated as a separate corporation for purposes of:

(A) Federal tax liabilities of the QSub with respect to any taxable period for which the QSub was treated as a separate corporation.

(B) Federal tax liabilities of any other entity for which the QSub is liable.

(C) Refunds or credits of Federal tax.

(ii) *Examples.* The following examples illustrate the application of paragraph (a)(6)(i) of this section:

*Example 1.* X has owned all of the outstanding stock of Y, a domestic corporation that reports its taxes on a calendar year basis, since 2001. X and Y do not report their taxes on a consolidated basis. For 2003, X makes a timely S election and simultaneously makes a QSub election for Y. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for Y's 2001 taxable year. Because Y was treated as a separate corporation for its 2001 taxable year, Y is the proper party to sign the consent to extend the period of limitations.

*Example 2.* The facts are the same as in *Example 1*, except that in 2004, the IRS determines that Y miscalculated and underreported its income tax liability for 2001. Because Y was treated as a separate

corporation for its 2001 taxable year, the deficiency for Y's 2001 taxable year may be assessed against Y and, in the event that Y fails to pay the liability after notice and demand, a general tax lien will arise against all of Y's property and rights to property.

*Example 3.* X is a QSub of Y. In 2001, Z, a domestic corporation that reports its taxes on a calendar year basis, merges into X in a state law merger. Z was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, X is the successor to Z and is liable for all of Z's debts. In 2003, the IRS seeks to extend the period of limitations on assessment for Z's 2000 taxable year. Because X is the successor to Z and is liable for Z's 2000 taxes that remain unpaid, X is the proper party to execute the consent to extend the period of limitations on assessment.

(iii) *Effective date.* This paragraph (a)(6) applies on or after April 1, 2004.

**PART 301—PROCEDURE AND ADMINISTRATION**

■ **Par. 4.** The authority citation for part 301 continues to read, in part, as follows:

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

■ **Par. 5.** Section 301.7701–2 is amended as follows:

■ 1. Paragraph (c)(2)(iii) is added.

■ 2. Paragraph (e) is revised.

The addition and revision read as follows:

**§ 301.7701–2 Business entities; definitions.**

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iii) *Tax liabilities of certain disregarded entities—(A) In general.* An entity that is otherwise disregarded as separate from its owner is treated as an entity separate from its owner for purposes of:

(1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded.

(2) Federal tax liabilities of any other entity for which the entity is liable.

(3) Refunds or credits of Federal tax.

(B) *Examples.* The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:

*Example 1.* In 2001, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2000 taxable year. Because Z is the successor to X and is liable for X's

2000 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

*Example 2.* The facts are the same as in *Example 1*, except that in 2002, the IRS determines that X miscalculated and underreported its income tax liability for 2000. Because Z is the successor to X and is liable for X's 2000 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

\* \* \* \* \*

(e) *Effective date.* (1) Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997, except that paragraph (b)(6) of this section applies on or after January 14, 2002, to a business entity wholly owned by a foreign government regardless of any prior entity classification, and paragraph (c)(2)(ii) of this section applies to taxable years beginning after January 12, 2001. The reference to the Finnish, Maltese, and Norwegian entities in paragraph (b)(8)(i) of this section is applicable on November 29, 1999. The reference to the Trinidadian entity in paragraph (b)(8)(i) of this section applies to entities formed on or after November 29, 1999. Any Maltese or Norwegian entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any Finnish entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997. However, paragraph (d)(3)(i)(D) of this section applies on or after October 22, 2003.

(2) Paragraph (c)(2)(iii) of this section applies on or after April 1, 2004.

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

Approved: February 15, 2005.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury.*

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**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 25**

[TD 9181]

RIN 1545-BB72

**Qualified Interests**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations amending the regulations under the gift tax special valuation rules to provide that a unitrust or annuity interest payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to the expiration of the term, is a qualified interest for the specified term. The final regulations also clarify that the exception treating a spouse's revocable successor interest as a retained qualified interest applies only if the spouse's annuity or unitrust interest, standing alone, would constitute a qualified interest that meets the requirements of § 25.2702-3(d)(3), but for the grantor's revocation power.

**DATES:** The regulations are effective July 26, 2004.

**FOR FURTHER INFORMATION CONTACT:** Juli Ro Kim (202) 622-3090 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background**

On July 26, 2004, the IRS published in the **Federal Register** (69 FR 44476) a notice of proposed rulemaking (REG-163679-02) conforming the gift tax regulations defining a qualified interest for purposes of section 2702 to the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq. in result*, Notice 2003-72, 2003-2 C.B. 964. In *Walton*, the court declared *Example 5* of § 25.2702-3(e) to be invalid. The notice of proposed rulemaking also clarifies those parts of the regulations under section 2702 addressing revocable spousal interests that were at issue in *Schott v. Commissioner*, 319 F.3d 1203 (9th Cir. 2003), *rev'g and remanding* T.C.M. 2001-110, and *Cook v. Commissioner*, 269 F.3d 854 (7th Cir. 2001), *aff'g* 115 T.C. 15 (2000).

No public hearing was requested or held, but one written comment and some telephone comments were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding

proposed regulations are removed. The comments and revisions to the proposed regulations are discussed below.

**Summary of Comments**

Generally, the commentators agreed with the amendments conforming the regulations to the *Walton* decision. Several commentators requested that the regulations address the amount includible in the grantor's gross estate with respect to a *Walton*-type grantor retained annuity trust (GRAT), if the grantor dies during the GRAT term, including the application of Rev. Rul. 82-105 (1982-1 C.B. 133). In addition, several commentators requested guidance regarding the application of section 2035 if the grantor dies within three years after termination of the term of the GRAT (or grantor retained unitrust (GRUT)). These suggestions were not adopted. The determination of the amount includible in the grantor's gross estate is an issue different from and governed by different Code sections than the definition of a qualified interest for purposes of section 2702, and is thus beyond the scope of this project. However, Treasury and IRS will consider addressing that issue in future guidance.

Regarding the proposed regulations addressing revocable spousal interests, commentators suggested that section 2702 was enacted to avoid valuation problems and that, because the value of the contingent revocable spousal interest at issue in *Schott v.*

*Commissioner* is readily determinable using actuarial tables, such an interest should be a qualified interest (as the Ninth Circuit concluded in *Schott*).

Treasury and the IRS continue to believe that the proposed regulations properly implement section 2702 and the policy underlying the statute. Uncertainty in valuation is not the only valuation inaccuracy that the statute was intended to correct. A valuation inaccuracy is also present when the value of a retained interest is increased through the use of a joint and survivor (or two-life) annuity or unitrust interest if there is no certainty that the survivorship interest will ever be paid. The revocable spousal interest involved in *Schott* may best be described as speculative, because it takes effect, if at all, only if the grantor fails to survive the term of the trust, and the duration of the interest, if it takes effect at all, is dependent on the portion of the term remaining at the grantor's death. The existing regulations make it clear that the ability to actuarially determine an interest is not sufficient to secure recognition of that interest as a qualified interest for purposes of section 2702.