addition would adequately represent that interest.

Dated: December 11, 1998.

Kevin Gover,

Assistant Secretary—Indian Affairs.

[FR Doc. 98–33443 Filed 12–16–98; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–106219–98]

RIN 1545–AW32

Acquisition of an S Corporation by a Member of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 1502. The proposed regulations provide specific rules that apply to the acquisition of the stock of an S corporation by an affiliated group of corporations that joins in the filing of a consolidated return. These rules eliminate the compliance burdens associated with filing a separate return for the day that an S corporation is acquired by a consolidated group. Additionally, the proposed regulations clarify that § 1.1502–76(c) continues to provide rules for the filing of the separate return for a corporation's items for the period not included in the consolidated return. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by March 10, 1999. Outlines of topics to be discussed at the public hearing scheduled for March 31, 1999, at 10 a.m. must be received by March 17, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–106219–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–106219–98), 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, Jeffrey L. Vogel, (202) 622–7770; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 1502 of the Internal Revenue Code of 1986 (the consolidated return regulations). The amendments apply to acquisitions by a consolidated group of at least eighty percent of the stock of an S corporation. When a consolidated group acquires an S corporation, the interaction of the consolidated return regulations and the subchapter S rules requires the filing of a separate return for the day of the acquisition. In most situations, complying with this requirement results in an unnecessary administrative burden for taxpayers.

The proposed regulations also clarify the impact of the 1994 revisions to § 1.1502–76(b) (TD 8560, 1994–2 C.B. 200). The 1994 revisions provided taxpayers greater certainty and prevented inconsistent allocations of items between a separate and a consolidated return. The proposed regulations clarify that the due date for the filing of the separate return for the period not included in the consolidated return continues to be governed by the rules in § 1.1502–76(c).

Acquisition of an S Corporation

Section 1.1502–76(b)(1)(i) provides that a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the consolidated return year and each subsidiary's items for the portion of the year for which the subsidiary is a member. Generally under § 1.1502–76(b)(1)(ii)(A), a subsidiary becomes a member of the consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all Federal income tax purposes. The subsidiary's items for the period beginning on the day after it becomes a member of the consolidated group are generally included in the consolidated return of the group. The subsidiary's items for the period prior to its becoming a member generally are included in a separate return.

A small business corporation's selection under section 1362(a) to be an S corporation terminates under section 1362(d)(2) if it ceases to be a small business corporation. A small business corporation cannot have a corporate shareholder. Thus, an S corporation election terminates when the corporation has another corporation as a shareholder. The termination is effective on the day the corporation becomes a shareholder. When the termination of an S corporation election becomes effective on any day other than the first day of the taxable year, the taxable year in which the termination occurs is an S termination year under section 1362(e)(4). The S termination year is comprised of a short taxable year for which the corporation is an S corporation (the portion of the S termination year ending on the day before the terminating event occurs, or S short year) and a short taxable year for which the corporation is a C corporation (the remainder of the S termination year, or C short year).

Under section 1362(e)(6)(D), if there is a change in ownership of 50 percent or more of the stock in a corporation during the S termination year, items of income, gain, loss, deduction, and credit must be allocated between the S short year and the C short year on the basis of the corporation's normal method of accounting, as determined under section 446 (also referred to as a closing of the corporation's books) as of the close of the S short year, rather than a daily proration or other method. The S short year and the C short year are treated as two separate taxable years for most purposes. Separate returns are required for the S short year and the C short year, and the due date for the S short year return is the date by which the C short year return must be filed.

When an S corporation becomes a member of a consolidated group, the interaction of the consolidated return regulations and the subchapter S rules results in the corporation having three taxable periods for the year of the acquisition for which Federal income tax returns are due: (1) an S short year that ends on the day before the acquisition by the consolidated group, (2) a C short year consisting solely of the day of the acquisition, and (3) a short taxable year (included in the consolidated return) for any items occurring after the day of the acquisition. Although three separate taxable periods are created when an S corporation becomes a member of a consolidated group, existing rules preclude an allocation of items properly attributable to either the C short year or the consolidated year to the S short

year, for example, through a daily proration of the items attributable to the year of the acquisition. Section 1362(e)(6)(D).

The IRS and Treasury have determined that the compliance burdens associated with filing a separate return for the day that an S corporation is acquired by a consolidated group are not necessary to achieve the separate goals of section 1362(e) and the consolidated return regulations. The proposed regulations will eliminate this requirement in most situations, while preserving the purpose and effect of the rules under section 1362(e). These proposed regulations will not apply, however, if an S corporation becomes a member of a consolidated group in a qualified stock purchase for which an election under section 338(g) is made. If the common parent of the consolidated group and the shareholders of the S corporation jointly make a section 338(h)(10) election, the administrative relief provided by these proposed regulations is unnecessary because the S corporation election of the old target corporation does not terminate. See § 1.338(h)(10)–1(e)(2)(iv).

Under the proposed regulations, an S corporation will become a member of the consolidated group at the beginning of the day that includes the acquisition, and its tax year will end for all Federal income tax purposes at the end of the day preceding the acquisition. Thus, instead of three short taxable years, the corporation will have two short taxable years as a result of the acquisition: (1) the period ending on the day before the S corporation joins the consolidated group, which will be treated as a taxable year in which the corporation was an S corporation, and (2) the period during which the corporation is a member of the consolidated group. The termination of an S corporation election under section 1362(d)(2) continues to become effective on the day of the acquisition. However, because the consolidated return regulations create a separate taxable year for the corporation, the first day of which is the day on which the S corporation election terminates, there is no S termination year within the meaning of section 1362(e)(4). Consequently, section 1362(e) technically does not apply to the corporation.

Notwithstanding that there is no there is no S termination year, the proposed regulations provide rules similar to those that would have applied under section 1362(e). Under the proposed regulations, as under section 1362(e)(1)(A), the S corporation's short taxable year ends at the end of the day preceding the date of the acquisition. The Federal income tax return for the final taxable year of the S corporation will be due at the earlier of: (1) The date the S corporation return would have been due if the taxable year of the S corporation did not end or (2) the date the consolidated group's return for the taxable year that includes the acquisition is due.

These proposed regulations also preclude the availability of ratable allocation under § 1.1502–76(b)(2)(ii) and (iii) in order to achieve the same results that would have obtained if section 1362(e)(6)(D) had applied. Accordingly, if an S corporation joins a consolidated group and these proposed regulations apply, then items must be allocated between the two short taxable years that begin and end with the corporation joining the consolidated group on the basis of a closing of the books rather than a ratable allocation of the type that would have been available under section 1362(e)(2) (in the case of the termination of an S corporation election) or § 1.1502–76(b)(2)(ii) and (iii) (in the case of a corporation becoming or ceasing to be a member of a consolidated group).

Due Date for Separate Return

Section 1.1502–76(b) provides guidance regarding the items to be included in a consolidated return. Items for the portion of a year not included in the consolidated return must be included in a separate return.

Section 1.1502–76(b)(1)(ii)(A) provides that a subsidiary becomes (or ceases to be) a member of the consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all Federal income tax purposes. Section 1.1502–76(b)(2)(i) generally provides that the returns that end and begin with a subsidiary becoming (or ceasing to be) a member of the consolidated group are subject to the rules of the Internal Revenue Code applicable to short periods, as if the subsidiary ceased to exist on becoming a member (or first existed on becoming a nonmember). Section 1.1502–76(c) provides rules for the filing of the separate return for the period the subsidiary was not included in the consolidated group.

The IRS and Treasury are concerned that a broad application of the provisions of § 1.1502–76(b) could be construed to require an accelerated filing of the separate return by the fifteenth day of the third month following the end of the short taxable year that resulted from the corporation joining or leaving the consolidated group. This interpretation would, in effect, override the provisions in § 1.1502–76(c) concerning the due date for the filing of a separate return.

The IRS and Treasury did not intend to modify the due date for the separate return for the period not included in the consolidated return by the changes in § 1.1502–76(b) (as amended by TD 8560). This proposed regulation clarifies that § 1.1502–76(c) continues to provide rules for the filing of the separate return.

Proposed Effective Date

The amendments relating to the acquisition of a corporation that, immediately before becoming a member, had an election under section 1362(a) in effect, are proposed to apply to transactions occurring after the date final regulations are published in the **Federal Register**. The amendments relating to the clarification of the due date for the separate return for items not included in the return of a consolidated group are proposed to apply to corporations that became or ceased to be members of consolidated groups on or after January 1, 1995, the effective date of the 1994 amendments to § 1.1502–76(b).

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 is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the proposed regulations will provide administrative relief to small entities by removing the administrative burden of filing a separate one-day return currently required for certain acquisitions. 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 RevenueCode, 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 comments that are submitted timely (a signed original and eight (8) copies) to the IRS. All comments will be made available for public inspection and copying.

A public hearing has been scheduled for March 31, 1999, at 10 a.m. in room 2615, Internal Revenue Building,

1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

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

Persons that wish to present oral comments at the hearing must submit written comments (a signed original and eight (8) copies) by March 10, 1999. The outline of topics to be discussed and the time to be devoted to each topic must be received by March 17, 1999.

A period of 10 minutes will be allotted 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 regulations is Jeffrey L. Vogel 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 * * *

Section 1.1502–76 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1362–3 is amended by adding a sentence to the end of paragraph (a) to read as follows:

§ 1.1362–3 Treatment of S termination year.

(a) *In general.* * * * See, however, § 1.1502–76(b)(1)(ii)(A)(*2*) for special rules for an S election that terminates under section 1362(d) immediately before the S corporation becomes a member of a consolidated group (within the meaning of § 1.1502–1(h)).

* * * * *

Par. 3. Section 1.1502–76 is amended as follows:

1. The text of paragraph (b)(1)(ii)(A) is redesignated as paragraph (b)(1)(ii)(A)(*1*).

2. A paragraph heading for newly designated paragraph(b)(1)(ii)(A)(*1*) is added.

3. The first sentence of newly designated paragraph(b)(1)(ii)(A)(*1*) is revised.

4. Paragraph (b)(1)(ii)(A)(*2*) is added.

5. Paragraph (b)(2)(v) is redesignated as paragraph(b)(2)(vi).

6. New paragraph (b)(2)(v) is added.

7. Paragraph (b)(5) is redesignated as paragraph (b)(6).

8. Paragraph (b)(4) is redesignated as paragraph (b)(5).

9. New paragraph (b)(4) is added.

10. Newly designated paragraph (b)(5) is amended as follows:

a. The first sentence of paragraph (b)(5), *Example 6*(b) is revised.

b. The second sentence of paragraph (b)(5), *Example 6*(c) is revised.

c. Example 7 is added to paragraph (b)(5).

11. Newly designated paragraph (b)(6)(i) is revised.

The revisions and additions read as follows:

§ 1.1502–76 Taxable year of members of group.

* * * * *

(b) * * * (1) * * *

(ii) * * * (A) * * * (*1*) *In general.* If a corporation (S), other than one described in paragraph (b)(1)(ii)(A)(*2*), becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. * * *

(*2*) *Special rule for former S corporations.* If S becomes a member in a transaction other than in a qualified stock purchase for which an election under section 338(g) is made, and immediately before becoming a member an election under section 1362(a) was in effect, then S will become a member at the beginning of the day the termination of its S corporation election is effective. S's tax year ends for all Federal income tax purposes at the end of the preceding day. This paragraph (b)(1)(ii)(A)(*2*) applies to transactions occurring after the date that final regulations are published in the **Federal Register**.

* * * * *

(2) * * *

(v) *Acquisition of S corporation.* If a corporation is acquired in a transaction to which paragraph (b)(1)(ii)(A)(*2*) of this section applies, then paragraphs (b)(2)(ii) and (iii) of this section do not apply and items of income, gain, loss, deduction, and credit are assigned to each short taxable year on the basis of the corporation's normal method of accounting as determined under section 446. This paragraph (b)(2)(v) applies to transactions occurring after the date that final regulations are published in the **Federal Register**.

* * * * *

(4) *Determination of due date for separate return.* Paragraph (c) of this section contains rules for the filing of the separate return referred to in this paragraph (b). In applying paragraph (c) of this section, the due date for the filing of S's separate return shall also be determined without regard to the ending of the tax year under paragraph (b)(1)(ii) of this section or the deemed cessation of its existence under paragraph (b)(2)(i) of this section.

* * * * *

(5) * * *

Example 6. Allocation of partnership items. * * *

(b) *Analysis.* Under paragraph (b)(2)(vi)(A) of this section, T is treated, solely for purposes of determining T's tax year in which the partnership's items are included, as selling or exchanging its entire interest in the partnership as of P's sale of T stock. * * *

(c) *Controlled partnership.* * * * Under paragraph(b)(2)(vi)(B) of this section, T's distributive share of the partnership items is treated as T's items for purposes of paragraph (b)(2) of this section. * * *

Example 7. Acquisition of S corporation. (a) *Facts.* Z is a small business corporation for which an election under section 1362(a) was in effect at all times since Year 1. At all times, Z had only 100 shares of stock outstanding, all of which were owned by individual A. On July 1 of Year 3, P acquired all of the Z stock. P does not make an election under section 338(g) with respect to its purchase of the Z stock.

(b) *Analysis.* As a result of P's acquisition of the Z stock, Z's election under section 1362(a) terminates. See sections 1361(b)(1)(B) and 1362(d)(2). Z is required to join in the filing of the P consolidated return. See § 1.1502–75. Z's tax year ends for all Federal income tax purposes on June 30 of Year 3. If no extension of time is sought, Z must file a separate return for the period from January 1 through June 30 of Year 3 on or before March 15 of Year 4. See paragraph (b)(4) of this section. Z will become a member of the P consolidated group as of July 1 of Year 3. See paragraph (b)(1)(ii)(A)(*2*) of this section. P group's Year 3 consolidated return will include Z's items from July 1 to December 31 of Year 3.

(6) *Effective date*—(i) *General rule.* Except as provided in paragraphs

(b)(1)(ii)(A)(*2*) and (b)(2)(v) of this section, this paragraph (b) applies to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995.

* * * * *

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

[FR Doc. 98–32932 Filed 12–16–98; 8:45 am]

BILLING CODE 4830–01–U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–245562–96]

RIN 1545–AU46

Relief From Disqualification for Plans Accepting Rollovers

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Proposed regulations; amendment.

SUMMARY: This document contains an amendment to the proposed regulations that implements section 1509 of the Taxpayer Relief Act of 1997 (TRA '97). The proposed regulations provide guidance on the qualification of retirement plans which accept rollover contributions from employees. This amendment to the proposed regulations clarifies that it is not necessary for the distributing plan to have a favorable IRS determination letter in order for the receiving plan administrator to reach a reasonable conclusion that a contribution is a valid rollover contribution. This amendment applies to any qualified retirement plan receiving or distributing eligible rollover distributions.

DATES: Written comments must be received by March 17, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–245562–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–245562–96), 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.

FOR FURTHER INFORMATION CONTACT: Marjorie Hoffman, (202) 622–6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 22, 1995, Final Income Tax Regulations (TD 8619) under sections 401(a)(31) and 402(c) were published in the **Federal Register** (60 FR 49199). The final regulations provide guidance for complying with the Unemployment Compensation Amendments of 1992 (UCA). A proposed amendment to the regulations under section 401(a)(31) was published in the **Federal Register** on September 19, 1996 (REG–245562–96) (61 FR 49279).

UCA expanded the types of distributions from a qualified plan that are eligible to be rolled over to an individual retirement account or individual retirement annuity, or to another qualified plan that accepts rollovers (collectively referred to as eligible retirement plans). Such distributions are referred to as eligible rollover distributions. UCA also added a new qualification provision under section 401(a)(31) that requires qualified plans to provide employees with a direct rollover option. Under a direct rollover option, an employee may elect to have an eligible rollover distribution paid directly to an eligible retirement plan. The direct rollover option is provided in addition to the pre-existing rollover provisions under section 402. Thus, an employee who receives an eligible rollover distribution but who does not elect a direct rollover still has the option to roll over the distribution to an eligible retirement plan within 60 days of receipt.

The final regulations under section 401(a)(31) provide that a plan that accepts a direct rollover from another plan will not fail to satisfy section 401(a) or 403(a) merely because the plan making the distribution is, in fact, not qualified under section 401(a) or 403(a) at the time of the distribution if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified under section 401(a) or 403(a). The regulations provide, by way of example, that the receiving plan may reasonably conclude that the distributing plan was qualified under section 401(a) or 403(a) where, before the receiving plan accepted the rollover, the plan administrator of the distributing plan provided the receiving plan with a statement that the distributing plan had received an IRS determination letter indicating that the plan was qualified.

The relief provided in the 1996 proposed regulations under section 401(a)(31) would expand and clarify the guidance previously issued in the Final Income Tax Regulations under sections 401(a)(31) and 402(c). First, the proposed regulations would clarify and expand the relief from disqualification currently provided for plans that accept direct rollovers. The protection would be expanded to be available not only if the plan administrator reasonably concludes the distributing plan is qualified under section 401(a) or 403(a) (even if later it is determined that the distributing plan is not a qualified plan), but also if the plan administrator reasonably concludes that a distribution meets the other requirements to be an eligible rollover distribution (but later it is determined that this conclusion was incorrect). Second, the regulations would extend this expanded relief from disqualification to plans that accept rollover contributions other than direct rollover contributions.

The 1996 proposed regulations do not mandate any particular documentation or procedures that a plan administrator must use in order to reach a reasonable conclusion that a rollover is valid. The 1996 proposed regulations contain a series of examples to illustrate the types of documentation and procedures that would be sufficient to support this conclusion. In each example, the employee making the rollover contribution provides the plan administrator with a letter from the plan administrator of the distributing plan stating that the distributing plan has received an IRS determination letter indicating that the distributing plan is qualified under section 401(a). In response to concerns that the examples might be read to imply that only a distribution from a plan with a favorable IRS determination letter could support a reasonable conclusion that a rollover was valid, section 1509 of TRA '97 directs the IRS to issue guidance clarifying that it is not necessary for the distributing plan to have a favorable IRS determination letter in order for the plan administrator of the receiving plan to reasonably conclude that a contribution is a valid rollover contribution.

Explanation of Provisions

This amendment to the 1996 proposed regulations is being issued in response to the congressional directive in section 1509 of TRA '97 to clarify that it is not necessary for a distributing plan to have a favorable IRS determination letter in order for the receiving plan administrator to reasonably conclude that a contribution is a valid rollover