

level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction. As of January 1, 1996, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of \$2,000 and an adjusted basis of \$2,000. On January 1, 1996, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of \$8,000 and an adjusted basis of \$5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled \$6,000. Under § 1.1254-2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under § 1.1254-3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal \$6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a *pro rata* share of X's section 1254 costs. The *pro rata* share of X's section 1254 costs that is allocated to A equals \$1,200 (20 percent interest in X multiplied by X's \$6,000 of section 1254 costs). The *pro rata* share of X's section 1254 costs that is allocated to B equals \$4,800 (80 percent interest in X multiplied by X's \$6,000 of section 1254 costs).

Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property. As of January 1, 1996, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of \$20,000 and an adjusted basis of \$14,000. A's and B's section 1254 costs with respect to Property P are \$4,000 and \$1,500, respectively. On January 1, 1996, C contributes \$20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a *pro rata* share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(i)(B) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal \$4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal \$1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals \$6,000. C's *pro rata* share of the \$6,000 of section 1254 costs equals \$3,000 (C's 50 percent interest in X multiplied by \$6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by \$2,000 (A's actual section 1254 costs (\$4,000) multiplied by 50 percent). B's section 1254 costs are reduced by \$750 (B's actual section 1254 costs (\$1,500) multiplied by 50 percent).

Example 3. Merger involving an S corporation that holds natural resource recapture property. X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of \$120,000 and an adjusted basis of \$40,000. A has section 1254 costs with respect to the property of \$60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of \$120,000 and basis of \$120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a *pro rata* share of its \$60,000 of section 1254 costs. Thus, A and B are each allocated \$30,000 of section 1254 costs (50 percent interest in X, each, multiplied by \$60,000).

(h) *Effective date.* This section applies to dispositions of natural resource recapture property by an S corporation (and a former S corporation) and dispositions of S corporation stock occurring after publication of these regulations as final regulations in the Federal Register.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

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26 CFR Part 31

[IA-33-95]

RIN 1545-AT77

Effective Date of Temporary Backup Withholding Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In the Rules and Regulations section of this issue of the Federal Register, the IRS is issuing temporary regulations relating to the effective date of the Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983, relating to backup withholding, statement mailing requirements, and due diligence. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments and requests for a public hearing must be received by March 20, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA-33-95), room 5228, Internal Revenue Service, POB

7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (IA-33-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Renay France, (202) 622-4910; concerning submissions, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in the Rules and Regulations section of this issue of the Federal Register amend the Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983 (26 CFR part 35a). The temporary regulations contain rules relating to the effective date of §§ 35a.9999-1, 35a.9999-2, 35a.9999-3, 35a.9999-3A, 35a.9999-4T, and 35a.9999-5.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. 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 Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may 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