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TD 9453

A foreign corporation is generally treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions) three conditions are satisfied. First, the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. Second, after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation. Third, after the acquisition the expanded affiliated group (defined in section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Similar provisions apply to transactions involving the acquisition by a foreign corporation of substantially all of the properties constituting a trade or business of a domestic partnership. The level of ownership in the surrogate foreign corporation by former shareholders of the domestic corporation (or former partners in the domestic partnership) determines the treatment of the transaction. Compare sections 7874(a)(1) and 7874(b).

Temporary regulations (TD 9265) were published in the Federal Register (71 FR 32437) on June 6, 2006, concerning the treatment of a foreign corporation as a surrogate foreign corporation (2006 temporary regulations). A notice of proposed rulemaking (REG-112994-06) cross-referencing the temporary regulations was published in the same issue of the Federal Register (71 FR 32495). On July 28, 2006, Notice 2006-70 (2006-2 CB 252), (see § 601.601(d)(2)(ii)(b)) was published, announcing that the effective date in § 1.7874-2T(j) would be amended for certain acquisitions initiated prior to December 28, 2005. No public hearing was requested or held; however, comments were received. After consideration of the comments, the 2006 temporary regulations and the related notice of proposed rulemaking are withdrawn and replaced with new temporary regulations and a new notice of proposed rulemaking. These new temporary regulations are discussed in this preamble.

Summary of Temporary Regulations

A. Stock Held by a Partnership

Section 1.7874-1T(b), as contained in 26 CFR part 1 revised as of April 1, 2008, provided that, for purposes of section 7874(c)(2)(A), stock held by a partnership shall be considered as held proportionately by the partners of the partnership. Final regulations published in the Federal Register (73 FR 29054-29058) on May 20, 2008 (2008 final regulations) modified this provision to apply for all purposes of section 7874. See § 1.7874-1(e). By its terms, § 1.7874-1(e) applies only to stock held by a partnership, not to all properties held by the partnership.

Commentators have questioned the scope of § 1.7874-1(e). In response to these comments, the temporary regulations modify the rule to apply only for purposes of determining whether the ownership condition of section 7874(a)(2)(B)(ii) is satisfied. The temporary regulations provide other partnership look-through rules, as appropriate. See, for example, the discussion in section F.4. of this preamble concerning the partnership items that are taken into account for purposes of section 7874(a)(2)(B)(iii).

B. Indirect Acquisition of Properties

1. Clarification of Temporary Regulations

The 2006 temporary regulations identify certain acquisitions that constitute indirect acquisitions of properties held by a domestic corporation. See § 1.7874-2T(b). The temporary regulations retain these rules and clarify that the identified transactions do not represent an exclusive list of transactions that constitute indirect acquisitions. The temporary regulations also clarify that the acquisition of an interest in a partnership is an indirect acquisition of a proportionate amount of the properties of the partnership for purposes of section 7874(a)(2)(B)(i).

2. Certain Acquisitions by Members of the Expanded Affiliated Group

The 2006 temporary regulations provide that if a corporation (acquiring corporation) acquires stock or assets of a domestic corporation in exchange for stock of a foreign corporation (foreign issuing corporation) that directly or indirectly owns more than 50 percent of the stock (by vote or value) of the acquiring corporation after the acquisition, the foreign issuing corporation shall be treated as acquiring a proportionate amount of the stock or assets of the domestic corporation. § 1.7874-2T(b)(4).

The temporary regulations retain this rule, with modifications. First, the rule is modified to apply if the acquiring corporation and the foreign issuing corporation are members of the same expanded affiliated group after the acquisition. Second, the rule is modified to apply to an acquisition of properties of a partnership. Finally, the rule is modified to apply if a partnership acquires properties of a domestic corporation (or partnership) in exchange for stock of a foreign issuing corporation, but only if the foreign issuing corporation and the partnership would be members of the same expanded affiliated group after the acquisition if the partnership were a corporation.

C. Acquisitions by Multiple Foreign Corporations

The IRS and the Treasury Department have become aware of transactions intended to avoid section 7874 that involve two or more foreign corporations completing, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i). For example, pursuant to a plan (or a series of related transactions), two foreign corporations would collectively acquire substantially all of the properties held by a domestic corporation. Taxpayers may take the position that neither foreign corporation is a surrogate foreign corporation because no foreign corporation separately acquires substantially all of the properties held by the domestic corporation. Taxpayers may also take the position that section 7874(c)(4) does not apply to these transactions.

Even if substantially all of the properties held by a domestic corporation (or constituting a trade or business of a domestic partnership) are not acquired by a single foreign corporation, this type of transaction presents the policy concerns that prompted the enactment of section 7874.

Accordingly, the temporary regulations provide that, if pursuant to a plan (or a series of related transactions) two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i), then each foreign corporation shall be treated as completing the acquisition for purposes of determining whether such foreign corporation shall be treated as a surrogate foreign corporation. See also section 7874(c)(4).

D. Acquisition of Multiple Domestic Corporations (or Partnerships)

The preamble to the 2008 final regulations identifies another transaction intended to avoid section 7874 that involves a single foreign corporation completing more than one acquisition described in section 7874(a)(2)(B)(i) as part of the same plan (or a series of related transactions). The preamble to the 2008 final regulations explains that the IRS and the Treasury Department disagree with the characterization of this type of transaction for purposes of section 7874 under current law and are considering issuing regulations clarifying the application of section 7874 to such transactions. In particular, the IRS and the Treasury Department disagree with the position that in determining whether the foreign corporation is a surrogate foreign corporation the ownership percentage under section 7874(a)(2)(B)(ii) is determined separately with respect to each domestic corporation (or partnership).

The preamble to the 2008 final regulations explains that any regulations issued would clarify that references in section 7874(a)(2)(B) to "a domestic corporation" shall, as appropriate, mean "one or more domestic corporations" where the properties of more than one domestic corporation are, directly or indirectly, acquired by a foreign corporation pursuant to the same plan. See § 1.368-2(h). The preamble indicates that similar clarifications would be made for transactions involving domestic partnerships.

The temporary regulations clarify that if a foreign corporation completes more than one acquisition described in section 7874(a)(2)(B)(i) pursuant to a plan (or a series of related transactions), then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions shall be treated as a single acquisition and the domestic corporations (and/or domestic partnerships) shall be treated as a single entity. This rule shall apply equally to transactions involving multiple corporations, multiple partnerships, or multiple corporations and partnerships.

The IRS and the Treasury Department determined that providing a specific operative rule was preferable to simply stating that, for purposes of section 7874(a)(2)(B), any reference to a single domestic corporation (or partnership) includes one or more domestic corporations (or partnerships). However, the operative rule of the temporary regulations is not a change from current law.

E. "By Reason of" Standard of Section 7874(a)(2)(B)(ii)

1. Distributions and Other Transactions

The 2006 temporary regulations provide that stock of a foreign corporation received by a former shareholder of a domestic corporation in exchange for stock of the domestic corporation is held by reason of holding stock in the domestic corporation. § 1.7874-2T(c)(1). Commentators have questioned whether an exchange is the exclusive means by which stock of a foreign corporation can be held by reason of holding stock in the domestic corporation. For example, one commentator questioned whether stock of a foreign corporation received by a former shareholder as a distribution with respect to the stock of the domestic corporation is held by reason of holding stock in the domestic corporation.

Section 7874(a)(2)(B)(ii) does not require stock of the foreign corporation to be received in exchange for stock of the domestic corporation (or an interest in the domestic partnership). Therefore, the temporary regulations clarify that the "by reason of" condition of section 7874(a)(2)(B)(ii) is satisfied if stock of a foreign corporation is received in exchange for, or with respect to, stock in a domestic corporation (or an interest in a domestic partnership). This includes a taxable or nontaxable distribution. The temporary regulations also clarify that the "by reason of" condition may be satisfied other than through exchanges or distributions.

2. Acquisitions Involving Other Property

One commentator questioned whether all the stock of a foreign corporation received by a former shareholder in exchange for stock of a domestic corporation and other property could be treated as held by reason of holding stock of the domestic corporation, if the other property bears some relationship to the stock of the domestic corporation.

In response to this comment, the temporary regulations clarify that, subject to section 7874(c)(4) and general tax principles, the "by reason of" standard applies based on the amount of stock of the foreign corporation received in exchange for, or with respect to, the stock of the domestic corporation (or interest in the domestic partnership). This determination is based on the relative values of the stock of the domestic corporation (or interest in a domestic partnership) and any other property exchanged for the stock of the foreign corporation. Thus, subject to section 7874(c)(4) and general tax principles, the "by reason of" standard is not affected by a relationship between stock of the domestic corporation (or interest in the domestic partnership) and such other property.

F. Substantial Business Activities Condition of Section 7874(a)(2)(B)(iii)

1. Removal of Safe Harbor and Examples

The third condition for the treatment of a foreign corporation as a surrogate foreign corporation is that, after the acquisition, the expanded affiliated group (defined in section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group (the substantial business activities condition). Section 7874(a)(2)(B)(iii). For purposes of determining whether the substantial business activities condition is satisfied, the 2006 temporary regulations provide a general rule that, with certain exceptions, is based on all the facts and circumstances, and a safe

harbor. § 1.7874-2T(d)(1) through (3). The 2006 temporary regulations also provide examples illustrating the application of the general rule. § 1.7874-2T(d)(4).

The IRS and the Treasury Department have concluded that the safe harbor provided by the 2006 temporary regulations may apply to certain transactions that are inconsistent with the purposes of section 7874, which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership). The temporary regulations, therefore, do not retain the safe harbor provided by the 2006 temporary regulations. The temporary regulations also do not retain the examples illustrating the general rule contained in the 2006 temporary regulations. Thus, taxpayers can no longer rely on the safe harbor or the examples illustrating the general rule provided by the 2006 temporary regulations. Instead, taxpayers must apply the general rule to determine whether the substantial business activities condition is satisfied. In addition, the question of whether the substantial business activities condition is satisfied will continue to be on the list of provisions with respect to which the IRS will not ordinarily issue rulings or determination letters. See Rev. Proc. 2009-7 (2009-1 IRB 226), Section 4.01(30). Comments are requested with respect to these changes.

2. Sales and Services Between Expanded Affiliated Group Members

The 2006 temporary regulations identify sales made by the expanded affiliated group to customers located in the foreign country as an item to consider in determining whether the substantial business activities condition is satisfied. § 1.7874-2T(d)(1)(ii)(3). Commentators have asked whether sales (or the performance of services) between expanded affiliated group members may be taken into account for this purpose.

The IRS and the Treasury Department are concerned that sales (and the performance of services) between expanded affiliated group members can be structured in a manner that does not represent actual business activities. However, subject to section 7874(c)(4) and general tax principles, the IRS and the Treasury Department believe that in appropriate circumstances sales (or the performance of services) between members of the expanded affiliated group may be taken into account under the general rule.

3. Items Not To Be Considered

The 2006 temporary regulations identify certain assets, activities, or income not to be taken into account in determining whether the substantial business activities condition is satisfied. See § 1.7874-2T(d)(1)(iii). See also section 7874(c)(4). The temporary regulations add to these items any assets, business activities, or employees located in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized if such assets, business activities or employees are transferred to another country pursuant to a plan in existence at the time of the acquisition.

4. Partnership Items

The 2006 temporary regulations provide that if one or more members of the expanded affiliated group own capital or profits interests in a partnership, the proportionate amount of certain items

of the partnership are considered to be items of the member (or members) of the expanded affiliated group. § 1.7874-2T(d)(3)(iv).

The temporary regulations retain and modify this provision to provide that, for purposes of the substantial business activities condition, a member of the expanded affiliated group that holds at least a 10 percent capital and profits interest in a partnership shall take into account its proportionate share of the items of the partnership, including business activities, employees, assets, income, and sales.

G. Publicly Traded Foreign Partnerships

1. Scope

For purposes of section 7874, the 2006 temporary regulations treat as a foreign corporation any foreign partnership that would, but for section 7704(c), be treated as a corporation under section 7704 at any time during the two-year period following the completion by the foreign partnership of an acquisition described in section 7874(a)(2)(B)(i). The IRS and the Treasury Department are concerned that taxpayers may be taking the position that the rule does not apply to a foreign partnership whose interests become publicly traded outside this two-year period, even if the public trading occurs pursuant to a plan that existed at the time of the acquisition.

To address these transactions, the temporary regulations modify the rule to apply to any foreign partnership that would, but for section 7704(c), be treated as a corporation under section 7704(a) at the time of the acquisition described in section 7874(a)(2)(B)(i), or at any time after the acquisition pursuant to a plan that existed at the time of the acquisition. For this purpose, a plan shall be deemed to exist at the time of the acquisition if the foreign partnership would, but for section 7704(c), be treated as a corporation under section 7704(a) at any time during the two-year period following the acquisition.

The temporary regulations also clarify that a publicly traded foreign partnership treated as foreign corporation under the rule is treated as a foreign corporation for all purposes of section 7874.

2. Implication Regarding Scope of Public Offering Rule

Section 1.7874-2T(e)(5), Example 3, involves a publicly traded foreign partnership that is treated as a surrogate foreign corporation under section 7874(a)(2)(B), but not as a domestic corporation under section 7874(b). In the example, the publicly traded foreign partnership acquires the stock of a domestic corporation in exchange for 75 percent of its outstanding interests. At the same time as the acquisition, an unrelated person acquires the remaining 25 percent interest in exchange for stock of a foreign corporation. The example concludes that the former shareholders of the domestic corporation hold 75 percent of the interests in the publicly traded foreign partnership by reason of holding stock of the domestic corporation. Implicit in this conclusion is that the 25 percent interest received by the unrelated person in exchange for the stock of the foreign corporation is not subject to the public offering rule of section 7874(c)(2)(B).

The IRS and the Treasury Department did not intend for this example to address the scope or application of the public offering rule of section 7874(c)(2)(B). The temporary regulations modify the example to eliminate the implication. The IRS and the Treasury Department are considering issuing guidance concerning the public offering rule of section 7874(c)(2)(B). Comments are requested in this regard.

H. Options and Similar Interests

The 2006 temporary regulations provide that, for purposes of section 7874(a)(2)(B)(ii), options and interests that are similar to options held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) shall be treated as exercised. Not addressed by the 2006 temporary regulations, however, is the treatment of options (or similar interests) or stock in a foreign corporation held by reason of holding options (or similar interests) in a domestic corporation (or a partnership, domestic or foreign). This issue may arise, for example, if the holder of a warrant to acquire stock of the domestic corporation exchanges the warrant for a warrant to acquire stock of the foreign acquiring corporation. The 2006 regulations also do not address the treatment of options (or similar interests) in a foreign corporation not held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership). Further, the IRS and the Treasury Department believe that treating options (or similar interests) as exercised may, in certain cases, lead to inappropriate results. For example, treating options (or similar interests) as exercised may distort the ownership of the foreign corporation for purposes of section 7874(a)(2)(B)(ii). For these reasons, the temporary regulations make the following changes to the rule provided by the 2006 temporary regulations.

1. Domestic Corporations (or Partnerships)

An option (or similar interest) represents a claim on equity to the extent the value of the stock (or partnership interest) that may be acquired pursuant to the option (or similar interest) exceeds the exercise price under the terms of the option (or similar interest). As a result, the temporary regulations provide that, for purposes of section 7874, an option (or similar interest) in a domestic corporation (or a partnership, domestic or foreign) shall be treated as stock of the domestic corporation (or an interest in the partnership) with a value equal to the holder's claim on the equity of the domestic corporation (or partnership) immediately before the acquisition described in section 7874(a)(2)(B)(i). For this purpose, the equity of the domestic corporation (or partnership) shall not include the value of any property the holder of the option (or similar interest) would be required to provide to the domestic corporation (or partnership) pursuant to the terms of the option (or similar interest) if such option (or similar interest) were exercised. Pursuant to these rules, for example, if the holder of an option in a domestic corporation receives stock of a foreign corporation by reason of holding the option, the holder shall be treated as holding the stock of the foreign corporation by reason of holding stock in the domestic corporation.

2. Foreign Corporations

The temporary regulations further provide that an option (or similar interest) in a foreign corporation shall generally be treated as stock of the foreign corporation with a value equal to the holder's claim on the equity of the foreign corporation immediately after the acquisition

described in section 7874(a)(2)(B)(i). As is the case for options (and similar interests) with respect to domestic corporations (or partnerships), for this purpose the equity of the foreign corporation shall not include the value of any property the holder of the option (or similar interest) would be required to provide to the foreign corporation pursuant to the terms of the option (or similar interest) if such option (or similar interest) were exercised. This rule shall not apply, however, if a principal purpose of the issuance or acquisition of an option (or similar interest) is to avoid the foreign corporation being treated as a surrogate foreign corporation.

3. Multiple Claims on Equity

The rules of the temporary regulations concerning options (or similar interests) shall not apply to the extent treating an option (or similar interest) as stock of a corporation (or an interest in a partnership) would duplicate, in whole or in part, a shareholder's (or partner's) claim on the equity of the corporation (or partnership). However, except to the extent otherwise provided in section 7874, stock of a corporation held by a shareholder, or an interest in a partnership held by a partner, shall in all cases be taken into account for purposes of section 7874.

4. Comments

The IRS and the Treasury Department request comments on the rules provided by the temporary regulations concerning options (or similar interests). For example, comments are requested as to whether the rules should not apply to certain options, such as publicly traded options or compensatory options. Comments are also requested on the general approach of the rules, which treats the option (or similar interest) as stock or a partnership interest to the extent of the holder's claim on equity, as compared to an approach that would deem the options (or similar interests) as exercised. Any comments should consider the potential impact of treating options (or similar interests) as exercised on the determination of ownership in the foreign corporation under section 7874(a)(2)(B)(ii).

I. Economically Equivalent Interests

The IRS and the Treasury Department have become aware of transactions intended to avoid section 7874 by using interests (such as stock or partnership interests) that, although not in form exchangeable or convertible into stock of a foreign corporation, are structured to be substantially equivalent to an equity interest in the foreign corporation. In one such transaction, for example, a privately held domestic corporation (UST) intends to make an initial public offering of its stock for cash. The UST shareholders, however, would prefer a foreign corporation to be the publicly-traded corporation.

To accomplish these objectives the following transactions are completed. A newly formed foreign corporation (FC) issues shares to the public in exchange for cash and then contributes all or part of the cash to a newly-formed domestic corporation (S) in exchange for all the stock of S. S then merges with and into UST. Pursuant to the merger agreement, the UST shareholders exchange their UST stock for a new class of UST stock (class B stock) and cash. FC exchanges its S stock for all of the remaining class of stock of UST (class A stock). FC holds few assets other than the class A stock.

The class B stock entitles the UST shareholders to dividend distributions approximately equal to any dividend distributions made by FC with respect to its publicly traded stock. The class B stock also permits the UST shareholders, in certain cases, to require UST to redeem the class B stock at fair market value. The class B stock does not provide the holder voting rights with respect to FC.

Because FC holds few assets other than the class A stock of UST, the value of the class B stock held by the former UST shareholders is approximately equal the value of a corresponding amount of FC stock. Further, the distribution and liquidity rights provided by the class B stock are intended to place the former UST shareholders in the same approximate economic position as if they had received publicly traded FC stock instead of the class B stock in the merger. Nonetheless, the former UST shareholders may take the position that they hold UST stock (and not FC stock) by reason of holding, in form, stock in UST and that the 2006 temporary regulations do not treat the class B stock as FC stock. For example, the former UST shareholders may take the position that the class B stock is not, in substance, an instrument other than debt that is convertible into stock of FC. See § 1.7874-2T(f)(2). The former UST shareholders may further take the position that section 7874(c)(4) does not apply to the transaction. If these positions are correct, FC would not be treated as a surrogate foreign corporation. The IRS and the Treasury Department understand that similar transactions may be structured using a partnership.

The IRS and the Treasury Department believe these transactions are contrary to the policies underlying section 7874. Therefore, the temporary regulations provide that, for purposes of section 7874, any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation (including under the rules concerning options (or similar interests)) shall be treated as stock of the foreign corporation if the following two conditions are satisfied: (1) The interest entitles the holder to distribution rights that are substantially similar in all material respects to the distribution rights entitled to a shareholder of the foreign corporation by reason of holding stock in the foreign corporation; and (2) treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation. For purposes of the first condition, distribution rights include rights to dividend distributions (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder's investment in the interest.

J. Insolvent Entities

The preamble to the 2008 final regulations describes a transaction involving an insolvent domestic corporation in which the creditors of the corporation claim not to be shareholders of the corporation for purposes of determining whether a foreign corporation that acquires substantially all of the properties held by the domestic corporation is treated as a surrogate foreign corporation. As further stated in the preamble, the IRS and the Treasury Department disagree with this interpretation under current law. See, for example, *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 [28 AFTR 567] (1942), and § 1.368-1(e)(6).

The temporary regulations clarify that, for purposes of section 7874, if immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a

domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then any claim by a creditor against the domestic corporation shall be treated as stock of the domestic corporation. Therefore, any stock of a foreign corporation held by a creditor of the domestic corporation by reason of its claim against the domestic corporation would be considered held by a former shareholder of the domestic corporation by reason of holding stock in the domestic corporation.

A similar rule applies with respect to a domestic or foreign partnership. Foreign partnerships are included in this rule because, for purposes of section 7874(a)(2)(B)(ii), the acquisition of an interest in a foreign partnership that owns stock of a domestic corporation is considered an acquisition of a proportionate amount of the stock of domestic corporation. Therefore, if a foreign corporation acquired a sufficient interest in that foreign partnership, the foreign corporation could be treated as a surrogate foreign corporation.

One commentator requested the regulations clarifying the treatment of creditors for purposes of section 7874 make clear that a creditor that is treated as a shareholder of a domestic corporation is treated as a shareholder for all purposes of section 7874. In particular, the commentator requested the regulations make clear that the provisions of the 2008 final regulations concerning the determination of the stock of a foreign corporation held by reason of holding stock of the domestic corporation apply equally to such a creditor. The IRS and the Treasury Department agree with this comment. Accordingly, the temporary regulations clarify that a creditor that is treated as a shareholder of a domestic corporation (or as a partner in a partnership) is treated as a shareholder (or partner) for all purposes of section 7874. Thus, for example, subject to section 7874(c)(4) and general tax principles, stock of the foreign corporation received by a creditor in exchange for other property would not be taken into account in determining former shareholder (or former partner) ownership under section 7874(a)(2)(B)(ii).

K. Modification to Internal Restructuring Exception of 2008 Final Regulations

The IRS and the Treasury Department have become aware of divisive transactions involving an acquisition described in section 7874(a)(2)(B)(i) in which the ownership condition of section 7874(a)(2)(B)(ii) may not be satisfied by reason of the internal group restructuring exception provided by § 1.7874-1(c)(2). For example, assume that a publicly-traded domestic corporation (USP) wholly owns a domestic subsidiary (S1) that in turn wholly owns another domestic subsidiary (S2). The S2 stock does not represent substantially all of the properties of S1. Pursuant to a plan, S2 transfers substantially all of its properties to a newly formed foreign corporation (F1) in exchange for F1 stock and then distributes the F1 stock to S1. Pursuant to the same plan, S1 distributes the F1 stock to USP, and USP then distributes the F1 stock to its shareholders.

The acquisition by F1 of substantially all of the properties held by S2 is described in section 7874(a)(2)(B)(i). In addition, S1, the former shareholder of S2, holds all the F1 stock by reason of holding S2 stock. However, taxpayer may take the position that the condition of section 7874(a)(2)(B)(ii) is not satisfied by reason of the internal group restructuring exception under § 1.7874-1(c)(2). In relevant part, the internal group restructuring exception provides that, for purposes of section 7874(a)(2)(B)(ii), stock of the foreign corporation held by a member of the expanded affiliated group shall be included in the denominator, but not in the numerator, of the

ownership fraction, if: (i) Before the acquisition, at least 80 percent of the stock (by vote and value) of the domestic corporation was held directly or indirectly by the corporation that is the common parent of the expanded affiliated group after the acquisition; and (ii) after the acquisition, at least 80 percent of the stock (by vote and value) of the acquiring foreign corporation is held directly or indirectly by such common parent. Taxpayer may take the position that the internal restructuring exception applies because before the acquisition USP indirectly owned 100 percent of the stock of S2 and after the acquisition USP indirectly owned 100 percent of the stock of F1. Therefore, the F1 stock held by S1 would be included in the denominator but not the numerator of the ownership fraction, yielding zero percent former shareholder ownership and resulting in F1 not being treated as a surrogate foreign corporation.

The IRS and the Treasury Department believe it is inappropriate for the internal restructuring exception to apply to divisive transactions such as the one described above. Accordingly, the IRS and the Treasury Department will issue regulations that determine former shareholder ownership under section 7874(a)(2)(B)(ii) when pursuant to the same plan (or a series of related transactions) that includes the acquisition described in section 7874(a)(2)(B)(i), all or part of the stock of the foreign corporation is transferred outside the expanded affiliated group that includes the foreign corporation after the acquisition. The regulations will provide that the internal group restructuring exception of § 1.7874-1(c)(2) does not apply to such transactions and will also modify the application of the general rule of § 1.7874-1(b) to such transactions. The regulations may apply to acquisitions completed on or after June 9, 2009.

L. Effective/Applicability Dates

The temporary regulations included in this document generally apply to acquisitions completed on or after June 9, 2009. However, taxpayers may apply the temporary regulations to acquisitions completed prior to June 9, 2009, if the temporary regulations are applied consistently to all acquisitions completed prior to such date.

The temporary regulations include the modifications announced by Notice 2006-70 (2006-2 CB 252) to the effective date paragraph of § 1.7874-2T, as contained in 26 CFR part 1 revised as of April 1, 2009, for certain acquisitions initiated prior to December 28, 2005.

No inference is intended as to the applicability of other Code or regulatory provisions, or judicial doctrines, to any transactions described in this preamble.

These regulations will expire on or before June 8, 2012.

Effect on Other Documents

Notice 2006-70 (2006-2 CB 252) is obsolete as of June 9, 2009.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to the temporary regulations.

The temporary regulations do not impose a collection of information. Pursuant to the Regulatory Flexibility Act (5 U.S.C. Chapter 6), it is also hereby certified that the temporary regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The complexity and cost of a transaction to which section 7874 may apply makes it unlikely that a substantial number of small entities will engage in such a transaction. In addition, the economic impact to any entities affected by section 7874 is derived from the application of the statute, and not from the temporary regulations. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business.

Drafting Information

The principal author of the temporary regulations is S. James Hawes, Office of Associate Chief Counsel (International). 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.

Amendments 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

Section 1.7874-1T also issued under 26 U.S.C. 7874(g).

Section 1.7874-2T also issued under 26 U.S.C. 7874(c)(6) and (g).

- Par. 2. Section 1.7874-1(e) is revised to read as follows:

§ 1.7874-1 Disregard of affiliate-owned stock.

(e) [Reserved]. For further guidance, see § 1.7874-1T(e).

• Par. 3. Section 1.7874-1T is added to read as follows:

§ 1.7874-1T Disregard of affiliate-owned stock (temporary).

(a) through (d) [Reserved]. For further guidance, see § 1.7874-1(a) through (d).

(e) Stock held by a partnership. For purposes of this section, each partner in a partnership shall be treated as holding its proportionate share of stock held by the partnership, as determined under the rules and principles of sections 701 through 777.

(f) [Reserved]. For further guidance, see § 1.7874-1(f).

(g) Effective/applicability date. Paragraph (e) of this section shall apply to acquisitions completed on or after June 9, 2009. See

§ 1.7874-1(e), as contained in 26 CFR part 1 revised as of April 1, 2009, for transactions completed before June 9, 2009.

(h) Expiration date. The applicability of this section expires on or before June 8, 2012.

• Par. 4. Section 1.7874-2T is revised to read as follows:

§ 1.7874-2T Surrogate foreign corporation (temporary).

(a) Scope. This section provides rules for determining whether a foreign corporation shall be treated as a surrogate foreign corporation under section 7874(a)(2)(B). Paragraph (b) of this section provides definitions and special rules. Paragraph (c) of this section provides rules to determine whether a foreign corporation has indirectly acquired properties held by a domestic corporation (or of a partnership). Paragraph (d) of this section provides rules that apply when two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i). Paragraph (e) of this section provides rules that apply when a single foreign corporation completes more than one acquisition described in section 7874(a)(2)(B)(i). Paragraph (f) of this section provides rules to identify the stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership). Paragraph (g) of this section provides rules concerning the substantial business activities condition of section 7874(a)(2)(B)(iii). Paragraph (h) of this section provides rules that treat certain publicly traded foreign partnerships as foreign corporations for purposes of section 7874. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides rules concerning the treatment of certain options (or similar interests) for purposes of section 7874. Paragraph (k) of this section provides rules that treat certain interests (including debt, stock, or a

partnership interest) as stock of a foreign corporation for purposes of section 7874. Paragraph (l) of this section is reserved. Paragraph (m) of this section provides rules concerning the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b).

Paragraph (n) of this section provides examples that illustrate the rules of this section. Paragraph (o) of this section provides the effective/applicability dates of this section. Paragraph (p) of this section provides the expiration date of this section.

(b) Definitions and special rules. Except as otherwise indicated, the following definitions and special rules apply for purposes of this section.

(1) The rules of this section are subject to section 7874(c)(4).

(2) An interest in a partnership includes a capital or profits interest.

(3) A former shareholder of a domestic corporation is any person that held stock in the domestic corporation before the acquisition described in section 7874(a)(2)(B)(i), including any person that holds stock in the domestic corporation both before and after the acquisition.

(4) A former partner of a domestic partnership is any person that held an interest in the domestic partnership before the acquisition described in section 7874(a)(2)(B)(i), including any person that holds an interest in the domestic partnership both before and after the acquisition.

(5) References to properties held by a domestic corporation include properties held directly or indirectly by the domestic corporation.

(6) The rules and principles of sections 701 through 777 shall be applied for purposes of determining a proportionate amount (or share) of items of a partnership (such as stock, properties, activities and employees).

(7) Any reference to the acquisition of properties held by a domestic corporation (or of a partnership) includes a direct or indirect acquisition of such properties.

(8) In the case of an acquisition of stock of a domestic corporation or an interest in a partnership, the proportionate amount of properties held by the domestic corporation (or of the partnership) that is treated as indirectly acquired shall, as applicable, be determined on the date of the acquisition based on the relative value of-

(i) The stock acquired compared to all outstanding stock of the domestic corporation; or

(ii) The interest acquired compared to all interests in the partnership.

(9) The determination of whether a foreign corporation is a surrogate foreign corporation is made after the acquisition described in section 7874(a)(2)(B)(i). A foreign corporation that is treated as

a surrogate foreign corporation (including a surrogate foreign corporation treated as a domestic corporation described in section 7874(b)) shall continue to be treated as a surrogate foreign corporation (or a domestic corporation), even if the conditions of section 7874(a)(2)(B)(ii) and (iii) are not satisfied at a later date.

(c) Acquisition of properties-

(1) Indirect acquisition of properties. For purposes of section 7874(a)(2)(B)(i), an indirect acquisition of properties held by a domestic corporation (or of a partnership) includes the acquisitions described in paragraphs (c)(1)(i) through (iv) of this section. An acquisition of less than all of the stock of a domestic corporation (or interests in a partnership) shall constitute an indirect acquisition of a proportionate amount of the properties held by the domestic corporation or of the partnership.

See paragraph (b)(8) of this section for rules determining the proportionate amount of properties indirectly acquired.

(i) An acquisition of stock of a domestic corporation. See Example 1 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(ii) An acquisition of an interest in a partnership. See Example 2 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(iii) An acquisition by a corporation (acquiring corporation) of properties held by a domestic corporation (or of a partnership) in exchange for stock of a foreign corporation (foreign issuing corporation) that is part of the expanded affiliated group that includes the acquiring corporation after the acquisition shall be treated as an acquisition by the foreign issuing corporation. See Example 3 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(iv) An acquisition by a partnership (acquiring partnership) of properties held by a domestic corporation (or of a partnership) in exchange for stock of a foreign corporation that is part of the expanded affiliated group that would include the acquiring partnership after the acquisition (if the partnership were a corporation) shall be treated as an acquisition by the foreign issuing corporation.

(2) Acquisition of stock of foreign corporation. An acquisition of stock of a foreign corporation that owns directly or indirectly stock of a domestic corporation (or an interest in a partnership) shall not constitute an indirect acquisition of any properties held by the domestic corporation (or the partnership). See Example 4 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(d) Acquisitions by multiple foreign corporations. If, pursuant to a plan (or a series of related transactions), two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i), then each foreign corporation shall be treated as completing the acquisition for purposes of determining whether such foreign corporation is

treated as a surrogate foreign corporation. See Examples 5 and 6 of paragraph (n) of this section for illustrations of the rules of this paragraph.

(e) Acquisitions of multiple domestic entities. If, pursuant to a plan (or a series of related transactions), a foreign corporation completes two or more acquisitions described in section 7874(a)(2)(B)(i) involving domestic corporations and/or domestic partnerships (domestic entities), then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions shall be treated as a single acquisition and the domestic entities shall be treated as a single domestic entity. If the transaction involves one or more domestic corporations and one or more domestic partnerships, the stock of the foreign corporation held by former shareholders and former partners by reason of holding stock or a partnership interest in the domestic entities shall be aggregated for purposes of determining whether the ownership condition of section 7874(a)(2)(B)(ii) is satisfied. See

Example 7 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(f) Stock held by reason of holding stock in a domestic corporation or an interest in a domestic partnership-

(1) Specified transactions. For purposes of section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) includes the stock described in paragraphs (f)(1)(i) through (iii) of this section.

(i) Stock of a foreign corporation received in exchange for, or with respect to, stock of a domestic corporation.

(ii) Stock of a foreign corporation received in exchange for, or with respect to, an interest in a domestic partnership.

(iii) To the extent that paragraph (f)(1)(ii) of this section does not apply, stock of a foreign corporation received by a domestic partnership in exchange for all or part of its properties. In such a case, each partner in the domestic partnership shall be treated as holding its proportionate share of the stock of the foreign corporation by reason of holding an interest in the domestic partnership.

(2) Transactions involving other property-

(i) Stock of a domestic corporation. If, pursuant to the same transaction, stock of a foreign corporation is received in exchange for, or with respect to, stock of a domestic corporation and other property, the stock of the foreign corporation that was received in exchange for, or with respect to, the stock of the domestic corporation shall be determined based on the relative value of the stock of the domestic corporation compared to the aggregate value of such stock and the other property.

(ii) Interest in a domestic partnership. If, pursuant to the same transaction, stock of a foreign corporation is received in exchange for, or with respect to, an interest in a domestic partnership and other property, the stock of the foreign corporation that was received in exchange for, or with respect to, the interest in the domestic partnership shall be determined based on the relative

value of the interest in the domestic partnership compared to the aggregate value of such interest and the other property.

(3) See Examples 8 through 10 of paragraph (n) of this section for illustrations of the rules of this paragraph (f).

(g) Substantial business activities-

(1) General rule. The determination of whether, after the acquisition, the expanded affiliated group that includes the foreign corporation has substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized when compared to the total business activities of the expanded affiliated group, is (subject to paragraph (g)(5) of this section) based on all facts and circumstances.

(2) Threshold of business activities. The determination of whether the expanded affiliated group has sufficient business activities in a foreign country is not solely based on the absolute amount of business activities in the foreign country. Rather the determination is based on a comparison of the amount of business activities in the foreign country to the total business activities of the expanded affiliated group. The determination must take into account the total business activities of the expanded affiliated group, including the relevant items identified in paragraph (g)(3) of this section. Thus, it is possible for the business activities of one expanded affiliated group in a particular country to be substantial when compared to the total business activities of such expanded affiliated group, but for identical business activities of another expanded affiliated group in the same country not to be substantial when compared to the total business activities of that other expanded affiliated group. This may result, for example, because the total business activities of the second expanded affiliated group are more extensive than that of the first expanded affiliated group.

(3) Items to be considered. Except as provided in paragraph (g)(5) of this section, relevant items to be considered for determining whether, after the acquisition, the expanded affiliated group has substantial business activities in a foreign country when compared to the total business activities of the expanded affiliated group include the items identified in paragraphs (g)(3)(i) through (v) of this section. The presence or absence of any item, or set of items, is not determinative and the weight given to any item, or set of items, depends on the facts and circumstances.

(i) The historical conduct of continuous business activities in the foreign country by the expanded affiliated group.

(ii) The conduct of continuous business activities in the foreign country by the expanded affiliated group in the ordinary course of one or more active trades or businesses, involving-

(A) Property located in the foreign country that is owned by members of the expanded affiliated group;

(B) The performance of services in the foreign country by employees of the expanded affiliated group; and

(C) Sales of goods to customers.

(iii) The performance in the foreign country of substantial managerial activities by officers and employees of the expanded affiliated group who are based in the foreign country.

(iv) A substantial degree of ownership of the expanded affiliated group by investors resident in the foreign country.

(v) Business activities in the foreign country that are material to the achievement of the overall business objectives of the expanded affiliated group.

(4) Attribution from a partnership. For purposes of this paragraph (g), a member of the expanded affiliated group that holds at least a 10 percent capital and profits interest in a partnership shall take into account its proportionate share of all the items of the partnership, including business activities, employees, assets, income and sales. See paragraph (b)(6) of this section for determining a partner's proportionate share of the items of a partnership.

(5) Items not to be considered. The following items shall not be taken into account in determining whether, after the acquisition, the expanded affiliated group has substantial business activities in a foreign country when compared to the total business activities of the expanded affiliated group.

(i) Any business activities or income attributable to properties or liabilities the transfer of which is disregarded under section

7874(c)(4).

(ii) Any assets, business activities, or employees located in a foreign country at any time as part of a plan with a principal purpose of avoiding the purposes of section 7874.

(iii) Any assets, business activities, or employees located in the foreign country in which, or under the law of which, the foreign corporation is created or organized if such assets, business activities or employees are transferred to another country pursuant to a plan that existed at the time of the acquisition described in section 7874(a)(2)(B)(i).

(h) Publicly traded foreign partnerships-

(1) Treatment as a foreign corporation. For purposes of section 7874, a publicly traded foreign partnership described in paragraph (h)(2) of this section shall be treated as a foreign corporation that is organized in the foreign country in which, or under the law of which, the publicly traded foreign partnership was created or organized, and interests in the publicly traded foreign partnership shall be treated as stock of the foreign corporation. For purposes of determining whether the foreign corporation shall be treated as a surrogate foreign corporation, a deemed acquisition of assets and liabilities by reason of § 1.708-1(b)(4) shall not constitute an acquisition described in section 7874(a)(2)(B)(i).

(2) Publicly traded foreign partnership. A publicly traded foreign partnership described in this paragraph (h)(2) is any foreign partnership that would, but for section 7704(c), be treated as a corporation under section 7704(a):

(i) At the time of the acquisition described in section 7874(a)(2)(B)(i); or

(ii) At any time after the acquisition pursuant to a plan that existed at the time of the acquisition. For this purpose, a plan shall be deemed to exist at the time of the acquisition if the foreign partnership would, but for section 7704(c), be treated as a corporation under section 7704(a) at any time during the two-year period following the completion of the acquisition.

(3) Surrogate foreign corporation to which section 7874(b) applies.

If paragraph (h)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, the publicly traded foreign partnership shall be treated as a domestic corporation for purposes of the Internal Revenue Code (Code). See paragraph (h)(6) of this section for the timing and treatment of the conversion of the publicly traded foreign partnership to a domestic corporation. See

Example 11 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(4) Surrogate foreign corporation to which section 7874(b) does not apply. If paragraph (h)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) does not apply, the publicly traded foreign partnership shall continue to be treated as a foreign partnership for purposes of the Code, but section 7874(a)(1) shall apply to any expatriated entity (as defined in section 7874(a)(2)(A)).

See Example 13 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(5) Foreign corporation not treated as a surrogate foreign corporation. If paragraph (h)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is not treated as a surrogate foreign corporation, the status of the publicly traded foreign partnership as a foreign partnership shall not be affected by section 7874. See Example 12 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(6) Conversion to a domestic corporation. Except for purposes of determining whether the publicly traded foreign partnership is a surrogate foreign corporation, if paragraph (h)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, then immediately before the first date properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i) the publicly traded foreign partnership shall be treated as transferring all of its assets and liabilities to a newly formed domestic corporation in exchange solely for stock of the domestic corporation, and then distributing such stock to its partners in proportion to their partnership interests in liquidation of the partnership. The treatment of the transfer of assets and liabilities to the domestic corporation and the distribution of the stock of the domestic corporation to the

partners in liquidation of the partnership shall be determined under all relevant provisions of the Code and general tax principles.

(i) [Reserved].

(j) Options and similar interests-

(1) Domestic corporation (or partnership). Except to the extent provided in this paragraph (j), for purposes of section 7874, an option (or similar interest) with respect to a domestic corporation (or a partnership, domestic or foreign) shall be treated as stock of the domestic corporation (or an interest in the partnership) with a value equal to the holder's claim on the equity of the domestic corporation (or partnership) immediately before the acquisition described in section 7874(a)(2)(B)(i). For this purpose, the equity of the domestic corporation (or partnership) shall not include the amount of any property the holder of the option (or similar interest) would be required to provide to the domestic corporation (or partnership) under the terms of the option (or similar interest) if such option (or similar interest) were exercised. See Example 16 of paragraph (n) of this section for an illustration of the rules of this paragraph.

(2) Foreign corporation-

(i) General rule. Except to the extent provided in this paragraph (j), for purposes of section 7874 an option (or similar interest) with respect to a foreign corporation shall be treated as stock of the foreign corporation with a value equal to the holder's claim on the equity of the foreign corporation after the acquisition described in section 7874(a)(2)(B)(i). For this purpose, the equity of the foreign corporation shall not include the amount of any property the holder of the option (or similar interest) would be required to provide to the foreign corporation under the terms of the option (or similar interest) if such option (or similar interest) were exercised. See Examples 14 through 16 of paragraph (n) of this section for illustrations of the rules of this paragraph (j)(2)(i).

(ii) Certain options (or similar interests) disregarded. Paragraph (j)(2)(i) of this section shall not apply to an option (or similar interest) if a principal purpose of the issuance or acquisition of the option (or similar interest) is to avoid the foreign corporation being treated as a surrogate foreign corporation.

(3) Similar interest. For purposes of this paragraph (j), an interest similar to an option (a similar interest) includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock or a partnership interest, a put, stock or a partnership interest subject to risk of forfeiture, a contract to acquire or sell stock or a partnership interest, and an exchangeable share or exchangeable partnership interest.

(4) Multiple claims on equity. Paragraphs (j)(1) and (j)(2)(i) of this section shall not apply to an option (or similar interest) to the extent treating the option (or similar interest) as stock of a corporation (or interest in a partnership) would duplicate a shareholder's (or partner's) claim on the equity of the corporation (or partnership) by reason of holding stock in the corporation (or an interest in the partnership). However, except to the extent otherwise provided in section 7874, in

all cases stock of a corporation held by a shareholder or an interest in a partnership held by a partner (without regard to this paragraph (j)) shall be taken into account for purposes of section 7874. See Example 15 of paragraph (n) of this section for an illustration of the rules of this paragraph (j)(4).

(k) Interests treated as stock of a foreign corporation-

(1) Stock or other interests. If the conditions of paragraphs (k)(1)(i) and (ii) of this section are satisfied, then, for purposes of section 7874, any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation (including under paragraph (j)(2)(i) of this section) shall be treated as stock of the foreign corporation. See Examples 17 and 18 of paragraph (n) of this section for illustrations of the rules of this paragraph (k)(1).

(i) The interest provides the holder distribution rights that are substantially similar in all material respects to the distribution rights provided by stock in the foreign corporation. For this purpose, distribution rights include rights to dividends (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder's investment in the interest.

(ii) Treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation.

(2) Creditor claims-

(i) Domestic corporation. For purposes of section 7874, if, immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then each creditor of the domestic corporation shall be treated as a shareholder of the domestic corporation and any claim of the creditor against the domestic corporation shall be treated as stock of the domestic corporation. See

Example 19 of paragraph (n) of this section for an illustration of the rules of this paragraph (k)(2)(i).

(ii) Domestic or foreign partnership. For purposes of section 7874, if, immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a partnership (foreign or domestic) is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the partnership exceed the value of its assets, then each creditor of the partnership shall be treated as a partner in the partnership and any claim of the creditor against the partnership shall be treated as an interest in the partnership.

(iii) Treatment of creditor as shareholder or partner. A creditor that is treated as a shareholder or partner under paragraph (k)(2)(i) or (ii) of this section shall be treated as a shareholder or partner for all purposes of section 7874. See, for example, § 1.7874-1(c) and paragraph (f) of this

section. See Example 19 of paragraph (n) of this section for an illustration of the rules of this paragraph (k)(2)(iii).

(l) [Reserved].

(m) Application of section 7874(b)-

(1) Conversion to a domestic corporation. Except for purposes of determining whether a foreign corporation is treated as a surrogate foreign corporation, the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b) shall constitute a reorganization described in section 368(a)(1)(F) that occurs immediately before the first date properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i). See, for example, § 1.367(b)-2 and 1.367(b)-3 for certain consequences of the reorganization. The treatment of all other aspects of the conversion shall be determined under the relevant provisions of the Code and general tax principles. See Example 20 of paragraph (n) of this section for an illustration of the rules of this paragraph (m)(1).

(2) Entity classification. A foreign corporation that is treated as a domestic corporation under section 7874(b) is not an eligible entity as defined in § 301.7701-3(a) of this chapter and therefore may not elect to be treated as other than an association for Federal tax purposes.

(3) Application of section 367. If a foreign corporation is treated as a domestic corporation under section 7874(b), section 367 shall not apply to any transfer of property by a United States person to such foreign corporation as part of the acquisition described in section 7874(a)(2)(B)(i). However, section 367 shall apply to the conversion of the foreign corporation to a domestic corporation. See paragraph (m)(1) of this section. See Example 20 of paragraph (n) of this section for an illustration of the rules of this paragraph (m)(3).

(n) Examples-

(1) Assumed facts. Except as otherwise stated, assume the following for purposes of the examples included in paragraph (n)(2) of this section.

(i) DC1 and DC2 are domestic corporations.

(ii) FA, FP, F1, F2, F3, and F4 are foreign corporations organized in Country A.

(iii) DPS is a domestic partnership that conducts a trade or business.

(iv) FPS is a foreign partnership that is not publicly traded.

(v) A, B, and C are unrelated individuals.

(vi) Each entity has a single class of equity outstanding and is unrelated to all other entities.

(vii) All transactions are completed pursuant to a plan.

(viii) All acquisitions of properties are completed after March 4,

2003.

(ix) Neither section 7874(c)(4) nor paragraph (j)(2)(ii) of this section applies.

(2) Examples. The following examples illustrate the rules of this section.

Example 1. Acquisition of stock of a domestic corporation. (i) Facts. FA acquires 25 percent of the outstanding stock of DC1.

(ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i) FA is treated as acquiring 25 percent of the properties held by DC1 on the date of the stock acquisition.

Example 2. Acquisition of a partnership interest. (i) Facts. DPS wholly owns DC1. FA acquires a 40 percent interest in DPS.

(ii) Analysis. Under paragraph (c)(1)(ii) of this section, for purposes of section 7874(a)(2)(B)(i) FA is treated as acquiring 40 percent of the DC1 stock held by DPS on the date of the acquisition of the partnership interest. Further, under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i) FA is treated as acquiring 40 percent of the properties held by DC1 on the date of the acquisition of the partnership interest.

Example 3. Acquisition of stock by a subsidiary. (i) Facts. FP wholly owns FA. FA acquires all the outstanding stock of DC1 in exchange solely for FP stock. FP and FA are members of the same expanded affiliated group after the acquisition.

(ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i) FA is treated as acquiring 100 percent of the properties held by DC1 on the date of the stock acquisition. Further, under paragraph (c)(1)(iii) of this section, for purposes of section 7874(a)(2)(B)(i) FP is also treated as acquiring 100 percent of the properties held by DC1 on the date of the stock acquisition. The result would be the same if instead FA had directly acquired all the properties held by DC1 in exchange for FP stock.

Example 4. Acquisition of stock of a foreign corporation. (i) Facts. FP wholly owns DC1. FA acquires all of the outstanding stock of FP.

(ii) Analysis. Under paragraph (c)(2) of this section, for purposes of section 7874(a)(2)(B)(i) FA is not treated as acquiring any properties held by DC1 on the date of the acquisition of the FP stock.

Example 5. Acquisition of stock by multiple foreign corporations. (i) Facts. Pursuant to the same plan, the shareholders of DC1 transfer all of their DC1 stock equally to F1, F2, F3, and F4 in exchange solely for stock of each foreign corporation.

(ii) Analysis. Under paragraph (c)(1)(i) of this section, in the aggregate F1, F2, F3 and F4 are treated as acquiring substantially all of the properties held by DC1. Because the acquisition was pursuant to the same plan, under paragraph (d) of this section, F1, F2, F3, and F4 are each treated as acquiring substantially all of the properties held by DC1 for purposes of determining whether each foreign corporation shall be treated as a surrogate foreign corporation.

Example 6. Acquisition of assets by multiple foreign corporations. (i) Facts. Individual A wholly owns DC1. DC1 forms F1, F2, F3, and F4, and transfers an equal portion of its properties to each corporation in exchange solely for stock of the corporation.

Pursuant to the same plan DC1 then distributes the stock of each foreign corporation to individual A.

(ii) Analysis. Because pursuant to the same plan F1, F2, F3 and

F4 acquired, in the aggregate, substantially all of the properties held by DC1, under paragraph (d) of this section, F1, F2, F3, and F4 are each treated as acquiring substantially all of the properties held by DC1 for purposes of determining whether each foreign corporation shall be treated as a surrogate foreign corporation.

Example 7. Acquisition of multiple domestic corporations. (i)

Facts. Individual A wholly owns DC1, and individual B wholly owns DC2. Pursuant to the same plan, A and B transfer all of their DC1 stock and DC2 stock to FA, a newly formed corporation, in exchange solely for all 100 shares of FA stock outstanding.

(ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i) FA is treated as acquiring all of the properties held by DC1 and DC2 on the date of the stock acquisition. Under paragraph (e) of this section, because pursuant to the same plan FA acquired substantially all of the properties held by DC1 and DC2, for purposes of determining whether FA shall be treated as a surrogate foreign corporation, DC1 and DC2 shall be treated as a single domestic corporation, of which A and B are former shareholders. Thus, individuals A and B are treated as holding all 100 shares of the FA stock by reason of holding stock of such domestic corporation, and the ownership fraction under section 7874(a)(2)(B)(ii) is 100/100, or 100 percent.

Example 8. Exchange of stock and other property. (i) Facts. Individual A wholly owns DC1 and F1. DC1 has a \$40x value and F1 has a \$60x value. Individual A transfers all of the DC1 stock and F1 stock to FA, a newly-formed corporation, in exchange solely for FA stock.

(ii) Analysis. Under paragraphs (f)(1)(i) and (f)(2)(i) of this section, for purposes of section 7874(a)(2)(B)(ii) individual A is considered to hold 40 percent of the FA stock by reason of holding stock in DC1 (\$100x FA stock multiplied by \$40x/\$100x, the relative value of the DC1 stock to all the property transferred by A to FA).

Example 9. Stock received as a distribution. (i) Facts. Pursuant to a divisive reorganization described in section 368(a)(1)(D), DC1 contributes substantially all of its properties to FA, a newly-formed corporation, in exchange solely for FA stock and then distributes the FA stock to its shareholders under section 355.

(ii) Analysis. Under paragraph (f)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(ii) the FA stock received by the DC1 shareholders as a distribution with respect to the DC1 stock is considered held by reason of holding stock in DC1. The result would be the same if the transaction did not qualify as a reorganization (for example, if the distribution were subject to sections 301 and 311(b)).

Example 10. Incorporation of a partnership trade or business.

(i) Facts. Individuals A and B equally own DPS. DPS transfers substantially all of its properties constituting a trade or business to FA, a newly-formed corporation, solely in exchange for FA stock. DPS retains the FA stock after the transaction.

(ii) Analysis. Under paragraph (f)(1)(iii) of this section, for purposes of section 7874(a)(2)(B)(ii) individuals A and B are treated as holding a proportionate amount (that is, an equal amount) of the FA stock held by DPS by reason of holding an interest in DPS.

Example 11. Publicly traded foreign partnership treated as domestic corporation. (i) Facts. Pursuant to a plan, DC1 and individual B organize a limited liability company (HPS) under the law of Country A. DC1 owns 99.9 percent of the membership interests in HPS, and B owns 0.1 percent of the membership interests in HPS.

HPS is a foreign eligible entity under § 301.7701-2 of this chapter, and DC1 and B make an election under § 301.7701-3 of this chapter to treat HPS as a partnership for Federal tax purposes as of the date of the formation of HPS. HPS forms DC2. DC2 merges with and into DC1. Pursuant to the merger agreement, the DC1 shareholders exchange their DC1 stock solely for membership interests in HPS. After the merger HPS wholly owns DC1, and the former shareholders of DC1 own a greater than 80 percent interest in HPS by reason of holding stock of DC1. Public trading of the HPS ownership interests begins the day after the date on which merger is completed. HPS is not treated as a corporation under section 7704(a) by reason of section 7704(c). If HPS were a corporation, the condition of section 7874(a)(2)(B)(iii) would be satisfied.

(ii) Analysis. HPS is a publicly traded foreign partnership that is described in paragraph (h)(2) of this section. Therefore, under paragraph (h)(1) of this section, for purposes of section 7874 HPS is treated as a foreign corporation organized under the law of Country A and the membership interests in HPS are treated as stock of the foreign corporation. The foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, pursuant to the merger, HPS acquired substantially all of the properties held by DC1, the former shareholders of DC1 hold at least 60 percent of the stock of the foreign corporation by reason of holding stock of DC1, and the expanded affiliated group that includes the foreign corporation does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Further, because the former shareholders of DC1 hold at least 80 percent of the stock of the foreign corporation by reason of holding stock of DC1, section 7874(b) applies to the surrogate foreign corporation, and therefore HPS is treated as a domestic corporation for purposes of the Code.

Under paragraph (h)(6) of this section, except for purposes of determining whether HPS is a surrogate foreign corporation, immediately before the merger of DC2 with and into DC1 HPS is treated as transferring all of its assets and liabilities to a new domestic corporation in exchange solely for stock of the domestic corporation. HPS is then treated as proportionately distributing such stock to its membership holders in liquidation of the partnership. In addition, as a result of the merger of DC2 with and into DC1, the former shareholders of DC1 shall be treated as receiving stock of a domestic corporation in exchange for their DC1 stock.

Example 12. Publicly traded foreign partnership not treated as a surrogate foreign corporation. (i) Facts. The facts are the same as in Example 11 of this section, except that, after the acquisition, the expanded affiliated group that includes HPS (treated as a foreign corporation for this purpose) has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

(ii) Analysis. Under paragraph (h)(1) of this section, for purposes of section 7874 HPS is treated as a foreign corporation and the membership interests in HPS are treated as stock of the foreign corporation. However, the foreign corporation is not treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, after the acquisition, the expanded affiliated group that includes HPS has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

Therefore, under paragraph (h)(5) of this section, section 7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under section 7874(a) by reason of the acquisition.

Example 13. Publicly traded foreign partnership treated as a surrogate foreign corporation but not as a domestic corporation. (i)

Facts. FPS is a publicly traded foreign partnership organized in Country A that, by reason of section 7704(c), is not treated as a corporation under section 7704(a). FPS acquires all the stock of DC1 in exchange for partnership interests in FPS. After the acquisition, the former shareholders of DC1 hold a 75 percent interest in FPS by reason of holding DC1 stock. After the

acquisition, the expanded affiliated group that includes FPS (treated as a foreign corporation for this purpose) does not have substantial business activities in

Country A when compared to the total business activities of the expanded affiliated group.

(ii) Analysis. Under paragraph (h)(1) of this section, for purposes of section 7874 FPS is treated as a foreign corporation and the partnership interests in FPS are treated as stock of the foreign corporation. FPS is treated as a surrogate foreign corporation because the conditions of section 7874(a)(2)(B) are satisfied.

However, because the former shareholders of DC1 hold less than an 80 percent interest in FPS by reason of holding DC1 stock, section 7874(b) does not apply to FPS. Therefore, under paragraph (h)(4) of this section FPS continues to be treated as a foreign partnership for purposes of the Code, but section 7874(a)(1) applies to DC1 and any other expatriated entity.

Example 14. Warrant to acquire stock from the foreign corporation. (i) Facts. Individual A wholly owns DC1. DC1 has a \$200x value. Individual B wholly owns FA. Individual C holds a warrant to acquire FA stock from FA at an exercise price of \$20x.

Individual A transfers all of its DC1 stock to FA in exchange solely for FA stock. At the time of the transfer, the FA stock that individual C can acquire pursuant to the warrant has a \$70x value.

(ii) Analysis. Under paragraph (j)(2) of this section, for purposes of section 7874 individual C is treated as owning FA stock with a \$50x value. This amount represents individual C's claim on the equity of FA after the acquisition (\$70x value of FA stock that may be acquired pursuant to the warrant, less \$20x exercise price), without taking into account the \$20x individual C would be required to provide to FA upon the exercise of the warrant.

Example 15. Option to acquire stock from another shareholder.

(i) Facts. The facts are the same as in Example 14 except that, instead of holding a warrant issued by FA, individual C holds an option to acquire FA stock from individual B for an exercise price of \$20x. At the time of the acquisition, the FA stock that individual C can acquire under the option has a \$70x value.

(ii) Analysis. Under paragraph (j)(4) of this section, for purposes of section 7874, individual C is not treated as owning FA stock by reason of holding the option because treating the option as FA stock would have the effect of partially duplicating individual B's claim on the equity of FA at the time of the acquisition by reason of holding FA stock. However, all of the FA stock owned by individual B shall be taken into account for purposes of section 7874.

Example 16. Warrant to acquire stock from the domestic corporation. (i) Facts. A DC1 employee holds a warrant to acquire DC1 stock from DC1. In connection with the acquisition by FA of substantially all of the properties held by DC1, the DC1 employee receives a warrant from FA to acquire 15 shares of FA stock in exchange for the warrant to acquire DC1 stock.

(ii) Analysis. Under paragraph (j)(1) of this section, for purposes of section 7874 the warrant held by the DC1 employee is treated as DC1 stock with a value equal to the employee's claim on the equity of DC1 immediately before the acquisition. Further, under paragraph (j)(2) of this section, for purposes of section 7874 the DC1 employee is treated as holding FA stock with a value equal to the employee's claim on the equity of FA after the acquisition by reason of holding the warrant to acquire DC1 stock (treated as DC1 stock for this purpose).

Example 17. Stock in a subsidiary treated as stock of a foreign parent corporation. (i) Facts. (A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. FA contributes part of the cash from the public offering to DC2, a newly-formed corporation, in exchange for all the stock of DC2. DC2 merges with and into DC1 with DC1 surviving.

Pursuant to the merger agreement, individuals A and B exchange their DC1 stock for cash and shares of class B stock of DC1. Following the merger FA owns all the class A stock of DC1. FA holds few assets other than the class A stock of DC1. Individuals A and B own all the class B stock of DC1. DC1 has no other class of stock outstanding.

(B) The class B stock entitles individuals A and B to dividend distributions approximately equal to any dividend distributions made by FA with respect to its publicly traded stock. In certain circumstances, the class B stock also permits individuals A and B to require DC1 to redeem the stock at fair market value. The class B stock does not provide individuals A and B voting rights with respect to FA.

(ii) Analysis. The dividend rights provided by the class B stock are substantially similar in all material respects to the dividend rights provided by the FA stock. In addition, because FA holds few assets other than the class A stock, the value of the class B stock held by individuals A and B is approximately equal to the value of a corresponding amount of publicly traded FA stock. The distribution rights on liquidation (or redemption) provided by the class B stock, therefore, are substantially similar in all material respects to the distribution rights on liquidation (or redemption) provided by the FA stock. As a result, the distribution rights provided by the class B stock are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. Thus, if treating the class B stock as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (k)(1) of this section the class B stock shall be treated as FA stock for purposes of section 7874.

Example 18. Partnership interest treated as stock of foreign acquiring corporation. (i) Facts. (A) Individuals A and B equally own DC1. FA, a newly-formed corporation, issues stock in a public offering for cash. Individuals A and B and FA organize FPS. FA transfers part of the cash from the public offering to FPS in exchange for a class A partnership interest. FA holds few assets other than the class A partnership interest. Individuals A and B transfer their DC1 stock to FPS in exchange for class B partnership interests.

(B) The class B partnership interests entitle individuals A and B to cash distributions from FPS approximately equal to any dividend distributions made by FA with respect to its publicly traded stock.

In certain circumstances, the class B partnership interests also permit individuals A and B to require FPS to redeem the interests in exchange for cash equal to the value of an amount of FA stock as determined on the redemption date. The class B partnership interests do not provide individuals A or B voting rights with respect to FA.

(ii) Analysis. The non-liquidating distribution rights provided by the class B partnership interests are substantially similar in all material respects to the dividend rights provided by the FA stock. Because FA holds few assets other than the class A partnership interest, the value of the class B partnership interests held by individuals A and B is approximately equal to a corresponding amount of FA stock. The distribution rights on liquidation (or redemption) provided by the class B partnership interests, therefore, are substantially similar in all material respects to distribution rights on liquidation (or redemption) provided by the FA stock. Thus, the distribution rights provided by the class B partnership interests are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. As a result, if treating the class B partnership interests as FA stock would have the effect of treating

FA as a surrogate foreign corporation, under paragraph (k)(1) of this section the class B partnership interests shall be treated as

FA stock for purposes of section 7874.

Example 19. Creditor treated as a shareholder. (i) Facts. Individuals A and B equally own DC1. The liabilities of DC1 exceed the value of its assets. Pursuant to a plan, FA, a newly-formed corporation, acquires substantially all of the properties held by DC1 in exchange solely for FA stock. Pursuant to the plan, the DC1 stock held by individuals A and B is cancelled, and the creditors of DC1 receive all the FA stock in exchange for their claims against DC1.

(ii) Analysis. Because immediately before the first date on which properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i) the liabilities of DC1 exceed the value of its assets, under paragraph (k)(2)(i) of this section, for purposes of section 7874 the creditors of DC1 are treated as shareholders of DC1 and the creditors' claims against DC1 are treated as DC1 stock. Therefore, for purposes of section 7874(a)(2)(B)(ii) the FA stock received by the creditors of DC1 by reason of their claims against DC1 is considered held by former shareholders of DC1 by reason of holding DC1 stock.

Example 20. Conversion to a domestic corporation and application of section 367. (i) Facts. Individuals A and B are United States persons and equally own DC1. Pursuant to a plan, individuals A and B transfer their DC1 stock to FA in exchange solely for 80 percent of the outstanding FA stock. After the acquisition, the expanded affiliated group that includes FA does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

(ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i) FA is treated as acquiring all of the properties held by DC1 on the date of the stock acquisition.

After the acquisition, the former shareholders of DC1 own 80 percent of the stock of FA by reason of holding DC1 stock. Therefore, FA is a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b). Under paragraph (m)(1) of this section, except for purposes of determining whether FA is treated as a surrogate foreign corporation, the conversion of FA to a domestic corporation shall constitute a reorganization described in section 368(a)(1)(F) that occurs immediately before the stock acquisition.

Section 367 applies to the conversion of FA to a domestic corporation. See, for example, § 1.367(b)-2 and 1.367(b)-3 for the consequences of the conversion. Under paragraph (m)(3) of this section, section 367 does not apply to the transfers of DC1 stock by individuals A and B to FA.

(o) Effective/applicability date-

(1) Temporary regulations filed on June 9, 2009. This section shall apply to acquisitions completed on or after June 9, 2009. However, taxpayers may apply this section to acquisitions completed before June 9, 2009, if this section is applied consistently to all acquisitions completed before such date.

(2) Application of prior temporary regulations to certain acquisitions completed on or after June 6, 2006. Section 1.7874-2T, as contained in 26 CFR part 1 revised as of April 1, 2009, shall not apply to acquisitions completed on or after June 6, 2006, pursuant to a written agreement that was (subject to customary conditions) binding on December 28, 2005, and at all times thereafter (binding commitment). A binding commitment shall include options and similar interests entered into in connection with one or more written agreements described in the preceding sentence. Accordingly, § 1.7874-2T, as contained in 26 CFR part 1 revised as of April 1, 2009, shall not apply to acquisitions that occur, in whole or in part, as a result of the exercise of such options or similar interests.

(p) Expiration date. The applicability of this section expires on or before June 8, 2012.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: June 8, 2009.

Michael Mundaca,
Acting Assistant Secretary of the Treasury (Tax Policy).
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