# Notice of Proposed Rulemaking

# Revision of Income Tax Regulations Under Sections 358, 367, and 884 Dealing With Statutory Mergers or Consolidations Under Section 368(a)(1)(A) Involving One or More Foreign Corporations

# REG–125628–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations amending the income tax regulations under various provisions of the Internal Revenue Code (Code) to account for statutory mergers and consolidations under section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) and (E)) involving one or more foreign corporations. These proposed regulations are issued concurrently with proposed regulations (REG–117969–00) that would amend the definition of a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law.

DATES: Written and electronic comments and requests to speak and outlines of topics to be discussed at the public hearing scheduled for May 19, 2005, at 10:00 a.m. must be received by April 28, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–125628–01), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–125628–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at: *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–125628–01). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Robert W. Lorence, Jr., (202) 622–3860; concerning submissions, the hearing, or placement on the building access list to attend the hearing, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received no later than March 7, 2005. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information can be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.367(a)–3(d)(2)(vi)(B)(*1*)(*ii*). This information is required to inform the IRS

of a domestic corporation that is claiming an exception from the application of section 367(a) and (d) to certain transfers of property to a foreign corporation that is re-transferred by the foreign corporation to a domestic corporation controlled by the foreign corporation. The information is in the form of a statement attached to the domestic corporation's U.S. income tax return for the year of the transfer certifying that if the foreign corporation disposes of the stock of the domestic controlled corporation with a tax avoidance purpose, the domestic corporation will file an income tax return (or amended return, as the case may be) reporting gain. The collection of information is mandatory. The likely respondents are domestic corporations.

Estimated total annual reporting burden: 50 hours.

Estimated average annual burden hours per respondent: 1 hour.

Estimated number of respondents: 50.

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## Background

Section 368(a)(1)(A) defines a reorganization to include a statutory merger or consolidation (A reorganization). For transactions completed before January 24, 2003, regulations under section 368(a)(1)(A) provided that a reorganization was a merger or consolidation effected pursuant to the corporation law of the United States or a State or Territory or the District of Columbia. See §1.368–2(b)(1), as in effect before January 24, 2003.

On January 24, 2003, the IRS and the Treasury Department issued proposed regulations (REG–126485–01, 2003–1 C.B. 542 [68 FR 3477]) and temporary regulations (T.D. 9038, 2003–1 C.B. 524 [68 FR 3384]), revising the definition of a statutory merger or consolidation. The proposed and temporary regulations define a statutory merger or consolidation in a manner intended to ensure that those transactions are not divisive in nature. Accordingly, the regulations generally require that all the assets and liabilities of the merged corporation (other than assets distributed or liabilities discharged in the transaction) are transferred to the acquiring corporation and that the separate legal identity of the merged corporation ceases to exist in the transaction.

Pursuant to a notice of proposed rulemaking (proposed section 368 regulations) published contemporaneously with this document, the IRS and Treasury are proposing further revisions to the definition of a statutory merger or consolidation to take into account those transactions effected pursuant to foreign law. The proposed section 368 regulations amend the 2003 proposed regulations and provide that an A reorganization may occur, if certain conditions are satisfied, pursuant to the laws of a foreign jurisdiction, including a U.S. possession.

In light of this change, this document contains proposed amendments to the regulations under certain international Code provisions (sections 367, 884, and 6038B) to account for statutory mergers and consolidations involving one or more foreign corporations. Current international tax regulations are premised on an A reorganization being limited to a statutory merger or consolidation involving domestic corporations effected pursuant to domestic law. See, *e.g.*, Rev. Rul. 57–465, 1957–2 C.B. 250. As a result, conforming changes must be made to these international tax regulations to ensure that they apply appropriately to statutory mergers and consolidations effected pursuant to foreign law. The proposed regulations also modify the section 367(a) and (b) regulations to address several other related issues.

## Explanation of Provisions

### A. *Basis and Holding Period Rules*

The proposed regulations provide basis and holding period rules for certain transactions involving foreign corporations with section 1248 shareholders in order to preserve relevant section 1248 amounts. A section 1248 shareholder is a U.S. person that satisfies the ownership requirements of section 1248(a) with respect to a foreign corporation. Section 1248(a) applies to a U.S. person that owns stock (directly, indirectly, or constructively) with 10 percent or more of the voting power in the foreign corporation at any time during the 5-year period ending on the sale or exchange of the stock when the foreign corporation was a controlled foreign corporation (CFC). Gain recognized by a section 1248 shareholder on the sale or exchange of stock of the foreign corporation is included in gross income as a dividend to the extent of the earnings and profits of the foreign corporation that are attributable to the stock sold or exchanged and that were accumulated while the stock was held by the U.S. person when the foreign corporation was a CFC (the section 1248 amount).

The IRS and Treasury believe that it is important to preserve section 1248 amounts in certain nonrecognition exchanges of foreign corporation stock. Preservation of section 1248 amounts is a function of the holding period and basis in the stock of the foreign corporation being exchanged. One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248 in connection with certain nonrecognition exchanges. H. Rep. No. 94–658, 94th Cong., 1st Sess., at 242 (Nov. 12, 1975). These proposed regulations provide basis and holding period rules to preserve section 1248 amounts in the context of certain section 354 exchanges and certain triangular reorganizations.

The basis and holding period rules of the proposed regulations also apply to a foreign corporate shareholder of a foreign corporation that is a party to the reorganization, provided that the foreign corporate shareholder has at least one U.S. person that is a section 1248 shareholder with respect to the foreign corporate shareholder and to the foreign corporation. This rule is necessary to preserve application of section 964(e) to the foreign corporate shareholder with respect to lower-tier foreign corporations. Under section 964(e), if a CFC sells or exchanges stock in another foreign corporation, gain recognized on the sale or exchange is included in the income of the CFC as a dividend to the same extent that it would have been included under section 1248(a) if the CFC were a U.S. person. Such dividend income may

be treated as subpart F income that is included in the income of U.S. shareholders of the CFC.

1. *Section 354 exchanges*

The proposed regulations apply to certain section 354 exchanges involving foreign corporations, including exchanges of multiple blocks of stock. The proposed regulations preserve the bases and holding periods in different blocks of stock in certain foreign target corporations by requiring the exchanging shareholder to establish the particular shares of stock that were received in exchange for shares of a particular block of target stock. If the exchanging shareholder cannot establish the particular shares of target stock that were received for shares of a particular block of stock, then the shareholder must designate which shares of stock were received in exchange for shares of a particular block of stock, provided that the designation is consistent with the terms of the exchange. These tracing methods are used to determine the resulting tax consequences when stock received in a nonrecognition exchange is subsequently sold or otherwise exchanged. If the exchanging shareholder cannot establish, and does not designate, the particular shares received, the shareholder is treated as selling or otherwise exchanging a share received in a nonrecognition exchange for a share that was purchased or acquired at the earliest time.

The IRS and Treasury recently published proposed section 358 regulations (REG–116564–03, 2004–20 I.R.B. 927) that determine the basis of stock or securities received in section 354 exchanges (proposed section 358 regulations). The proposed section 358 regulations generally provide that the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies will be the same as the basis of the share of stock or security exchanged therefor. For these purposes, the determination of which share of stock or security is received in exchange for a particular share of stock or security is made in accordance with the terms of the exchange or distribution.

These proposed regulations apply the principles of the proposed section 358 regulations to certain exchanges of stock of a foreign corporation by either a section 1248 shareholder, or a foreign corporate shareholder where at least one U.S. person is a section 1248 shareholder with respect to such foreign corporate shareholder and to the foreign corporation whose shares are exchanged (collectively and individually, section 367(b) shareholder), to ensure the preservation of section 1248 amounts. The proposed regulations also include specific guidance on the shareholder's holding period in the stock received in the section 354 exchange. The proposed regulations do not, however, apply to distributions described in section 355.

Consistent with the proposed section 358 regulations, the proposed regulations hereunder would not apply to section 351 exchanges or to exchanges to which both section 351 and section 354 (or section 356) apply, if, in addition to stock being received, other property is received or liabilities are assumed. This limitation is intended to prevent a conflict between the rules for determining basis in a section 351 exchange (including the application of section 357(c)) and the rules proposed in this document. The IRS and Treasury are considering approaches for the preservation of section 1248 amounts in section 351 transactions in which liabilities are assumed or other property is received, and comments are requested in this regard.

In addition, the IRS and Treasury are considering developing specific rules for situations in which stock of the foreign acquiring corporation is not issued in the exchange (for example, when the exchanging shareholder owns all the stock of the foreign acquiring corporation). One possible approach may be for each existing share of stock in that corporation to be divided into portions to account for the different basis and holding periods of the stock of the foreign acquiring corporation and the stock of the acquired corporation in order to preserve section 1248 amounts. Comments are requested regarding this approach or possible alternative approaches.

2. *Triangular reorganizations*

The proposed regulations provide special basis and holding period rules for triangular reorganizations where the merging or surviving corporation is a foreign corporation with a section 367(b) shareholder. These rules apply to reorganizations described in section 368(a)(1)(A) and (a)(2)(D) (forward triangular merger) and to parenthetical section 368(a)(1)(C) reorganizations. In these transactions, the surviving corporation (S) acquires substantially all the assets of the acquired corporation (T), and the T shareholders exchange their T stock for stock of the corporation (P) that is in control (within the meaning of section 368(c)) of S. These rules also apply to reorganizations described in section 368(a)(1)(A) and (a)(2)(E) (reverse triangular merger). In a reverse triangular merger, S, a controlled subsidiary of P, merges into T, the surviving corporation, and the T shareholders exchange their T stock for stock of P.

Under current regulations, in a forward triangular merger or a parenthetical C reorganization, P's basis in its S stock is adjusted as if P had acquired the T assets directly from T in a section 362(b) exchange and then had transferred the T assets to S in a transaction in which P's basis in S stock is determined under section 358. See §1.358–6(c)(1) (commonly referred to as the "over-the-top" basis rules). Under current regulations, in a reverse triangular merger, P's basis in the T stock it receives immediately after the transaction is equal to its basis in its S stock immediately before the transaction adjusted as if T had merged into S in a forward triangular merger and the over-the-top basis rules had applied. See §1.358–6(c)(2). If a reverse triangular merger also qualifies as a section 351 transfer or a section 368(a)(1)(B) reorganization, P can determine its basis in its S stock either by using the over-the-top basis rules as described in the prior sentence or by treating P as if it had acquired the T stock from the former shareholders of T in a transaction in which basis is determined under section 362(b) (carryover stock basis).

The IRS and Treasury are concerned that, in certain exchanges involving foreign corporations, application of the over-the-top basis rules would not properly preserve the section 1248 or 964(e) amounts with respect to the stock of S or T. The proposed regulations provide that, in determining the stock basis of the surviving corporation in certain triangular reorganizations, outside stock basis will be used instead of inside asset basis pursuant to §1.358–6(c). For example, in the case of a forward triangular merger (or a parenthetical C reorganization), where P is a do-

mestic corporation, S is a foreign corporation, T is a foreign corporation, and T has a section 1248 shareholder, the basis and holding period in the T stock, not the T assets, are used to determine P's basis in the S stock. The same rules apply to certain reverse triangular mergers, where S merges into T with T surviving. In that case, P's basis in the T stock immediately after the transaction would reflect the basis and holding period of the T stock instead of the T assets.

Under this stock basis approach for triangular reorganizations, the proposed regulations provide for a divided basis and holding period in each share of stock in the surviving corporation to reflect the relevant section 1248 amounts in the S stock and T stock. In particular, each share of S stock in a forward triangular merger, and each share of T stock in a reverse triangular merger, where P is a section 367(b) shareholder immediately after the transaction, is divided into portions reflecting the basis and holding period of the S stock and the T stock before the transaction. However, the proposed regulations contain a *de minimis* exception to this rule. Under this exception, if the value of the S stock immediately before the transaction is *de minimis* (for example, where S is a corporation formed to facilitate the transaction), then each share of the surviving corporation is not divided; instead, the basis of the S stock is added to the basis of the stock of the surviving corporation held by P. The value of the S stock would be *de minimis* for this purpose if it is less than 1 percent of the value of the surviving corporation (S or T) immediately after the transaction.

If there are two or more blocks of stock in T or S held by a section 367(b) shareholder immediately before the transaction, then each share of the surviving corporation (S or T) is further divided to account for each block of stock. If two or more blocks of stock are held by one or more shareholders that are not section 367(b) shareholders, then shares in these blocks are aggregated into one divided portion for basis purposes. If none of the S or T shareholders is a section 367(b) shareholder, then the over-the-top basis rules of §1.358–6 apply instead of the rules in these proposed regulations.

The proposed regulations provide special rules when stock of the surviving corporation has a divided basis and holding period. Earnings and profits accumulated prior to the reorganization are attributed to a divided portion of a share of stock based on the block of stock whose basis and holding period the divided portion reflects. Post-reorganization earnings and profits are attributed to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits attributed to a divided share of stock pursuant to section 1248 are further attributed to a divided portion of such share of stock based on its fair market value in relation to the other divided portions. Finally, shares of stock are no longer divided into separate portions if section 1248 or 964(e) becomes inapplicable to a subsequent sale or exchange of the stock.

The special basis rules in these proposed regulations apply to all triangular reorganizations where T has at least one section 367(b) shareholder, even if such shareholders own less than a controlling interest in T. The IRS and Treasury are considering whether the current basis rules of §1.358–6 should apply in cases where section 367(b) shareholders do not own a substantial percentage of the stock of T, or whether taxpayers should be permitted to elect to apply the current basis rules under §1.358–6 to determine P's basis in the stock of the surviving corporation (S or T), provided that all section 367(b) shareholders of T include in income the section 1248 amounts with respect to the stock exchanged. Comments are requested in this regard.

The use of stock basis to determine P's basis in the surviving corporation also presents administrative concerns when a portion of the stock of T is widely held. In the case of a reorganization described in section 368(a)(1)(B), which presents similar issues, Rev. Proc. 81–70, 1981–2 C.B. 729, provides that statistical sampling techniques, if appropriate, are permitted to determine the basis of stock received by the acquiring corporation. In this regard, the IRS and Treasury recently have requested comments whether Rev. Proc. 81–70 should be revised to reflect changes in the marketplace since its publication. See Notice 2004–44, 2004–28 I.R.B. 32. Comments are requested on expanding this guidance to apply under the proposed regulations, for example in cases where blocks of T stock are held by persons that are not section 367(b) shareholders and such shares are aggregated into a single divided portion for basis and holding period purposes.

B. *Exceptions to the Application of Section 367(a)*

Under section 367(a), a U.S. person recognizes gain, but not loss, on the transfer of property to a foreign corporation in an exchange described in section 351, 354, 356, or 361, unless an exception applies. Section 367(a), however, does not apply to a section 354 exchange by a U.S. person of: (1) stock of a foreign corporation in a section 368(a)(1)(E) reorganization; or (2) stock of a domestic or foreign corporation for stock of a foreign corporation in an asset reorganization described in section 368(a)(1)(C), (D), or (F) that is not treated as an indirect stock transfer under §1.367(a)–3(a).

The proposed regulations amend §1.367(a)–3(a) so that this exception to the application of section 367(a) also applies to A reorganizations (including forward and reverse triangular mergers). In addition, the proposed regulations clarify that §1.367(a)–3(a) applies to exchanges described in section 356, as well as in section 354. Section 356 applies to an exchange that would qualify as a section 354 exchange except for the fact that money or other property is received in the exchange.

Taxpayers have questioned why the exception to the application of section 367(a) in §1.367(a)–3(a) includes exchanges of stock but not exchanges of securities in section 368(a)(1)(E) reorganizations and certain asset reorganizations. The IRS and Treasury believe that it is appropriate to provide comparable treatment for exchanges of securities in this context. Accordingly, Notice 2005–6, 2005–5 I.R.B. 448), published contemporaneously with these proposed regulations, announces that the IRS and Treasury intend to amend §1.367(a)–3(a) to apply the exception from section 367(a) to exchanges of stock or securities. Notice 2005–6 applies to transfers of securities after January 5, 2005. Taxpayers also may apply the provisions of the notice to transfers of securities occurring on or after July 20, 1998, and on or before January 5, 2005. In applying this notice, however, taxpayers must do so consistently to all transactions within its scope.

The proposed regulations also provide rules concerning the application of section 367(a) to reverse triangular mergers, where stock of P, a corporation that controls the merging corporation S, is treated as transferred (along with any other property of S) to the surviving corporation T in a section 361 transfer. If S is a domestic corporation and T is a foreign corporation, section 367(a) applies to the transfer by S of the P stock to T, unless an exception applies.

The IRS and Treasury believe that, if the stock of P is provided to S pursuant to the plan of reorganization, the section 361 transfer of the P stock from S to T should not be subject to section 367(a), and the proposed regulations so provide. If P does not provide its stock to S pursuant to the plan of reorganization, then the P stock will be treated as property of S and the transfer of such stock will be subject to section 367(a).

The IRS and Treasury intend to amend the regulations under section 6038B to conform with the changes made in these regulations.

C. *Concurrent Application of Section 367(a) and (b)*

The proposed regulations modify the current application of section 367(a) and (b) to transactions that require the inclusion in income of the all earnings and profits amount under section 367(b). Section 1.367(a)–3(b)(2) provides rules for the concurrent application of section 367(a) and (b) to transfers of stock of a foreign corporation. This may occur, for example, when a U.S. shareholder exchanges stock of a foreign corporation (foreign acquired corporation) for stock of another foreign corporation (foreign acquiring corporation). See §1.367(a)–3(b)(1). It may also occur when an acquiring corporation (foreign or domestic) acquires the assets of a foreign acquired corporation, and the U.S. shareholder exchanges stock of the foreign acquired corporation for stock of the foreign parent of the acquiring corporation in a triangular reorganization.

The U.S. person's exchange of stock of the foreign acquired corporation for stock of either the foreign acquiring corporation or the foreign parent is subject to section 367(a). See §1.367(a)–3(b) and (d). If the exchanging U.S. shareholder owns 5 percent or more (by vote or value) of the stock of the foreign acquiring corporation or the foreign parent immediately after the exchange, the shareholder recognizes gain, if any, under section 367(a), unless the shareholder enters into a gain recognition agreement as provided in §1.367(a)–8. If the exchanging shareholder is not a 5-percent shareholder, then the exchanging shareholder does not recognize gain, if any, on the exchange.

The U.S. shareholder's exchange described above also may be subject to section 367(b). If the exchanging U.S. shareholder is a section 1248 shareholder of the foreign acquired corporation, and the stock of the foreign acquiring corporation (or its foreign parent corporation) is not stock in a corporation that is a CFC as to which the U.S. shareholder is a section 1248 shareholder immediately after the exchange, then the exchanging shareholder must include in income the section 1248 amount with respect to the stock exchanged. See §1.367(b)–4. If, instead, a domestic acquiring corporation acquires the assets of a foreign acquired corporation, and the U.S. shareholder exchanges stock of the foreign acquired corporation for stock of the foreign parent of the acquiring corporation in a triangular reorganization, then the exchanging shareholder must include in income the all earnings and profits amount with respect to the stock of the acquired corporation. See §1.367(b)–3. Unlike the section 1248 amount, the all earnings and profits amount is not limited by the shareholder's gain inherent in the stock of the foreign acquired corporation.

In cases where section 367(a) and (b) apply concurrently to a transaction, existing §1.367(a)–3(b)(2) provides that section 367(b) will not apply if the transfer is taxable under section 367(a). If the transfer is taxable under section 367(a), the exchanging U.S. shareholder will recognize gain inherent in the exchanged stock (subject to recharacterization as dividend income under section 1248). If the transfer is not taxable under section 367(a), because the exchanging U.S. shareholder either is not a 5-percent shareholder or enters into a gain recognition agreement, then section 367(b) applies and the exchange is subject to either §1.367(b)–3 or 1.367(b)–4 at the shareholder level.

Questions with respect to the concurrent application of section 367(a) and (b) have arisen in situations that otherwise would require inclusion of the all earnings and profits amount under §1.367(b)–3. If the all earnings and profits amount is greater than the section 367(a) gain with respect to the stock of the foreign acquired corporation, under current law the exchanging shareholder effectively may elect to be taxed on the lesser amount of gain under section 367(a) simply by failing to file a gain recognition agreement. In that case, section 367(b) would not apply and the shareholder would avoid inclusion in income of the greater all earnings and profits amount.

The ability to elect to recognize the lesser gain inherent in the stock exchanged in such cases is inconsistent with the policies of section 367(b) that apply to inbound transactions, including preventing conversion of tax deferral into tax forgiveness and ensuring that the domestic acquiring corporation's section 381 carryover basis reflects an after-tax amount. Accordingly, the IRS and Treasury believe that the all earnings and profits amount provisions under §1.367(b)–3 should not operate electively in these cases. The proposed regulations require that, for exchanges subject to §1.367(b)–3 and section 367(a), section 367(b) would apply before section 367(a). In that case, inclusion of the all earnings and profits amount would increase the exchanging shareholder's stock basis for purposes of computing the shareholder's gain under section 367(a). Thus, if the all earnings and profits amount exceeds the inherent gain in the exchanged stock, gain is not recognized under section 367(a). If the transaction does not involve inclusion of the all earnings and profits amount (for example, if §1.367(b)–4 applies), the existing ordering rules continue to apply.

D. *Parenthetical Section 368(a)(1)(B) Reorganizations*

In a parenthetical reorganization under section 368(a)(1)(B), if a U.S. shareholder exchanges stock of an acquired corporation for voting stock of a foreign corporation that controls (within the meaning of section 368(c)) the acquiring corporation, the U.S. shareholder is treated as making an indirect transfer of stock of the acquired corporation to the foreign con-

trolling corporation in a transfer subject to section 367(a). See §1.367(a)–3(d)(1)(iii). This result occurs even if the acquiring corporation is domestic. If the U.S. shareholder owns five percent or more (by vote or value) of the stock of the foreign controlling corporation, the shareholder must recognize gain inherent in the exchanged stock, unless a gain recognition agreement is filed. A gain recognition agreement filed with respect to the transfer may be triggered (and gain on the initial transfer of stock will be recognized) if the foreign controlling corporation disposes of the stock of the acquiring corporation, or the acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer. See §1.367(a)–3(d)(2)(ii).

The proposed regulations revise the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. shareholder exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls a foreign acquiring corporation. In such a case, the gain recognition agreement may be triggered if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation, or the foreign acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer.

E. *Transfers of Assets Following Certain Asset Reorganizations*

If a U.S. shareholder exchanges stock or securities of an acquired corporation for stock or securities of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C), and the foreign acquiring corporation transfers all or part of the assets of the acquired corporation to a subsidiary controlled (within the meaning of section 368(c)) by the foreign acquiring corporation in a transaction described in section 368(a)(2)(C), the U.S. shareholder is treated, for purposes of section 367(a), as transferring the stock of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. §1.367(a)–3(d)(1)(v). Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A), (B), (C), and (G) will not be disqualified because all or part of the assets or stock acquired in the transaction are transferred to a corporation controlled by the acquiring corporation.

On August 16, 2004, the IRS and Treasury issued proposed regulations under §1.368–2(k) that permit assets or stock acquired in any reorganization under section 368(a)(1) to be transferred to a corporation controlled by the acquiring corporation without disqualifying the reorganization. Prior to these proposed regulations, the IRS and Treasury issued Rev. Rul. 2002–85, 2002–2 C.B. 986, which extended this treatment to section 368(a)(1)(D) reorganizations. Notice 2002–77, 2002–2 C.B. 997, issued contemporaneously with Rev. Rul. 2002–85, provided that §1.367(a)–3(d)(1)(v) would be amended to treat transactions described in Rev. Rul. 2002–85 as indirect stock transfers, if the transfer of assets by the acquiring corporation to its controlled subsidiary occurred pursuant to the plan of reorganization.

The effect of the proposed regulations under §1.368–2(k) is to permit transfers of assets or stock to a controlled subsidiary in reorganizations not specifically identified or mentioned in section 368(a)(2)(C) (section 368(a)(1)(D) and (F) reorganizations). The proposed regulations amend the indirect stock transfer rules to conform to the changes in the section 368 regulations. As a result, the proposed regulations provide that the transfer of assets to a controlled subsidiary subsequent to an asset reorganization under section 368(a)(1) would constitute an indirect transfer of stock, provided the transfer of assets by the foreign acquiring corporation to its controlled subsidiary occurs as part of the same transaction.

F. *Indirect Transfers Involving a Change in Domestic or Foreign Status of Acquired Corporation*

As indicated above, under existing §1.367(a)–3(d)(1)(v), a U.S. shareholder of an acquired corporation is treated as transferring the stock of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. Thus, if the acquired corporation is foreign, the U.S. shareholder is treated as transferring stock of a foreign corporation to the foreign acquiring corporation in a transaction that is subject to the §1.367(a)–3(b) stock transfer rules. If the acquired corporation is domestic, the U.S. shareholder is treated as transferring stock of a domestic corporation to the foreign acquiring corporation in a transaction that is subject to §1.367(a)–3(c). This deemed transfer of domestic stock prevails even if the controlled subsidiary is foreign. Similar rules apply to parenthetical C reorganizations.

Some commentators have suggested that the determination of whether domestic or foreign stock is deemed transferred should be based on the status of the controlled subsidiary, rather than the status of the acquired corporation. Under this approach, if the acquired corporation were domestic and the controlled subsidiary were foreign, the U.S. shareholders would be deemed to transfer foreign corporation stock subject to §1.367(a)–3(b), rather than domestic corporation stock subject to §1.367(a)–3(c). The IRS and Treasury believe that, consistent with the framework of the current regulations, it is appropriate for the rules to continue to apply based on the stock that is owned and exchanged by the U.S. person in the transaction (rather than on the stock of the controlled subsidiary). The IRS and Treasury are considering the application of §§1.367(a)–3(b), 1.367(a)–3(c), and 1.367(a)–8 to situations where the foreign acquiring corporation transfers assets of the acquired corporation to multiple controlled subsidiaries (including both domestic and foreign subsidiaries), comments are requested in this regard.

G. *Coordination of the Indirect Stock Transfer Rules and the Asset Transfer Rules*

In the case of an indirect stock transfer that also involves a transfer of assets by a domestic corporation to a foreign corporation, §1.367(a)–3(d)(2)(vi) generally provides that section 367(a) and (d) apply to the transfer of assets prior to application of the indirect stock transfer rules. However, section 367(a) does not apply to such transfers to the extent that the foreign acquiring corporation transfers the assets received in the asset transfer to a domestic corporation controlled (within the meaning of section 368(c)) by the foreign acquiring corporation in a transfer described in section 368(a)(2)(C) or in a transfer de-

scribed in section 351, provided the domestic transferee's basis in the assets is no greater than the basis that the domestic acquired corporation had in such assets. The initial asset transfer to the foreign corporation is not subject to section 367(a) in such cases because the assets re-transferred to the domestic corporation remain subject to U.S. corporate tax.

The IRS and Treasury are concerned that asset reorganizations subject to this coordination rule may be used to facilitate corporate inversion transactions. An inversion generally involves a U.S. multinational corporation reincorporating outside the United States for tax purposes (either as a foreign corporation or as a subsidiary of a new foreign corporation). The IRS and Treasury also are concerned that the coordination rule might be used to facilitate divisive transactions. The proposed regulations address both of these concerns by modifying the scope of the coordination rule.

The revised coordination rule operates as follows. Section 367(a) and (d) generally apply to the transfer of assets to a foreign corporation even if the foreign corporation transfers all or part of the assets received to a controlled domestic corporation. This general rule, however, is subject to two exceptions which do not require income recognition under section 367(a) and (d) on the transfer of assets to the foreign corporation to the extent that assets are re-transferred to the domestic controlled corporation.

The first exception applies if the domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions provided in regulations under section 367(a)(5) are satisfied. Although there currently are no regulations under section 367(a)(5), this exception will incorporate any conditions or limitations in future regulations once published.

In cases where the first exception does not apply, the second exception applies if the following two conditions are satisfied: (1) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of §1.367(a)–3(c)(1)(i), (ii), and (iv), and (c)(6); and (2) the domestic acquired corporation attaches a statement (described below) to its tax return for the taxable year of the transfer.

The statement that the domestic acquired corporation files must certify that, if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation with a principal purpose of avoiding U.S. tax that would have been imposed on the domestic acquired corporation had it disposed of the re-transferred assets, the domestic acquired corporation will amend its return for the year of the initial transaction and recognize gain (described below). The disposition of stock is presumed to have a principal purpose of tax avoidance if the disposition occurs within 2 years of the transfer. The presumption may be rebutted, however, if the domestic acquired corporation (or the foreign acquiring corporation on its behalf) demonstrates to the satisfaction of the Commissioner that the transaction did not have a principal purpose of tax avoidance.

If the domestic acquired corporation recognizes gain pursuant to the statement, it is treated as if, immediately prior to the exchange, it had transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of the corporation in a transaction that is treated as a section 351 exchange, and immediately sold the stock to an unrelated party at fair market value in a sale in which it recognizes gain, if any, but not loss. For purposes of this rule, the deemed transfer to a domestic corporation is treated as a section 351 exchange regardless of whether all the requirements for nonrecognition under section 351 are otherwise satisfied. Treating the domestic acquired corporation as recognizing gain on the disposition of stock, rather than assets, is intended to approximate the consequences that would have resulted had the domestic acquired corporation transferred the assets to a corporation and sold the stock received in such transfer prior to the outbound reorganization. In addition, this treatment is consistent with other provisions that address divisive transactions. See, *e.g.*, section 355(e) and §1.367(e)-(2)(b)(2)(iii).

The basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation is increased by the amount of gain recognized by the domestic acquired corporation under these rules immediately prior to its disposition; however, the basis of the re-transferred assets held by the domestic controlled corporation will not be increased by such gain. Finally, the anti-abuse provision under §1.367(d)–1T(g)(6) will not apply to intangible property included in the re-transferred assets.

### H. *Application of Section 367(b) Regulations to Certain Triangular Reorganizations*

Section 367(b) applies to exchanges under sections 332, 351, 354, 355, 356, and 361 (except to the extent described in section 367(a)(1)) in which the status of a foreign corporation as a corporation for tax purposes is necessary for application of the relevant nonrecognition provisions. Except as provided in regulations, under section 367(b) a foreign corporation that is a party to such an exchange is considered to be a corporation for tax purposes, and therefore the parties involved in the transaction are eligible for nonrecognition treatment.

Section 1.367(b)–4 applies to acquisitions by a foreign corporation (the foreign acquiring corporation) of the stock or assets of another foreign corporation (the foreign acquired corporation) in certain nonrecognition exchanges (a section 367(b) exchange). Consistent with section 1248, §1.367(b)–4(b)(1)(i) addresses exchanges by a section 1248 shareholder (or, in certain cases, a CFC shareholder that has a section 1248 shareholder), and generally requires such a shareholder to include in income its section 1248 amount as a result of a section 367(b) exchange, if immediately after the exchange (i) the stock received in the exchange is not stock in a corporation that is a controlled foreign corporation as to which the section 1248 shareholder described above is a section 1248 shareholder, or (ii) the foreign acquiring corporation or the foreign acquired corporation (if any, such as in a transaction described in section 368(a)(1)(B) or 351), is not a controlled foreign corporation as to which the section 1248 shareholder described above is a section 1248 shareholder.

Therefore, in a triangular reorganization (such as a triangular reorganization described in section 368(a)(1)(C)) that is within the scope of §1.367(b)–4, a section 367(b) shareholder must include in income

the section 1248 amount if, for example, it receives stock of a domestic corporation in exchange for its stock in a controlled foreign corporation. This is the case because, immediately after the exchange, the section 367(b) shareholder does not hold stock in a corporation that is a controlled foreign corporation as to which such shareholder is a section 367(b) shareholder.

Pursuant to the basis rules contained in this proposed regulation under §1.367(b)–13, the section 1248 amount with respect to the stock of the foreign acquired corporation that is exchanged can be properly preserved in the stock of a foreign corporation owned by a domestic corporation when the section 367(b) shareholder receives stock of the domestic corporation in a triangular reorganization. Consequently, the proposed regulations provide that a section 367(b) shareholder receiving stock of a domestic corporation in a triangular reorganization is not required to include in income the section 1248 amount under §1.367(b)–4(b)(1)(i), provided that the domestic corporation, immediately after the exchange, is a section 1248 shareholder of the surviving corporation (or in the case of a parenthetical section 368(a)(1)(B) reorganization, of the acquired corporation) that is itself a controlled foreign corporation.

I. *Application of Section 367(b) Regulations to Certain Outbound Reorganizations*

If a domestic corporation is a section 1248 shareholder with respect to a foreign corporation and transfers the stock in such foreign corporation to another foreign corporation in a section 361 transfer, the domestic corporation must include in income the section 1248 amount, if any, with respect to the stock of the transferred foreign corporation. See section 1248(f)(1) and §1.367(b)–4(b)(2)(ii), *Example 4*.

Taxpayers have commented that this rule may result in income inclusions in some cases where the section 1248 amount could be preserved, such that a current inclusion may not be necessary or appropriate. The IRS and Treasury are considering the application of section 367(a)(5) and section 1248(f)(1) to such transactions, in conjunction with §1.367(b)–13 of these regulations, to preserve section 1248 amounts, and comments are requested in this regard. The IRS and Treasury also are considering, and request comments, on situations in which there are multiple shareholders (including minority shareholders) of the domestic corporation; multiple assets (including appreciated and depreciated assets being transferred as part of the section 361 transfer); and liabilities being assumed in connection with the transaction.

J. *Nonrecognition Transactions under the FIRPTA and PFIC Provisions*

Section 897(a) generally treats gain or loss from the disposition of a U.S. real property interest by a nonresident alien individual or a foreign corporation as gain or loss that is effectively connected with the conduct of a trade or business within the United States. Sections 897(d) and (e) provide rules that apply section 897 in the context of distributions and nonrecognition exchanges of U.S. real property interests. Temporary regulations were issued under sections 897(d) and (e) providing guidance on the application of section 897 to certain corporate transactions involving U.S. real property interests. See §1.897–5T, 1.897–6T, and Notice 89–85, 1989–2 C.B. 403. These rules do not specifically address A reorganizations because such regulations were based on A reorganizations being limited to statutory mergers between domestic corporations. The IRS and Treasury intend to revise these regulations to reflect A reorganizations and welcome comments on revisions that are necessary to apply these regulations to A reorganizations, as well as comments on other issues under the regulations.

Section 1291(f) provides authority to issue regulations concerning the exchange of stock in a passive foreign investment company (PFIC) in a nonrecognition transaction. Proposed regulations were published in the **Federal Register** (57 FR 11047) on April 1, 1992, providing rules for the disposition of PFIC stock by U.S. shareholders in nonrecognition exchanges. See §1.1291–6 of the proposed regulations. The application of these proposed regulations is based on A reorganizations being limited to statutory mergers between domestic corporations. The IRS and Treasury intend to revise these proposed regulations to reflect A reorganizations and welcome comments on revisions that are necessary in this regard, as well as comments on other issues under these regulations.

**Proposed Effective Date**

Except as otherwise specified, these regulations are proposed to apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

**Special Analyses**

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

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and on how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 19, 2005, beginning at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more

than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 28, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these regulations is Robert W. Lorence, Jr., of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

**Proposed Amendments to the Regulations**

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

PART 1—INCOME TAXES

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

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

Par. 2. In section 1.358–1, paragraph (a) is amended by adding a sentence at the end of the paragraph to read as follows:

*§1.358–1 Basis to distributees.*

(a) * * * In the case of certain section 354 or 356 exchanges of stock in a foreign corporation, §1.367(b)–13 applies instead of the rules of §1.358–2.

* * * * *

Par. 3. In §1.358–6, paragraph (e) is amended by adding a sentence at the end of the paragraph to read as follows:

*§1.358–6 Stock basis in certain triangular reorganizations.*

* * * * *

(e) * * * For certain triangular reorganizations where the surviving corporation (S or T) is foreign, see §1.367(b)–13.

* * * * *

Par. 4. Section 1.367(a)–3 is amended as follows:

1. In paragraph (a), remove the third and fourth sentences, and add five sentences in their place.
2. Revise paragraph (b)(2)(i).
3. Revise paragraph (c)(5)(vi).
4. In paragraph (d)(1), introductory text, first sentence, add the parenthetical "(or in a domestic corporation in control of a foreign acquiring corporation in a triangular section 368(a)(1)(B) reorganization)" after the words "for stock or securities in a foreign corporation".
5. In paragraph (d)(1), introductory text, remove the last sentence and add three sentences in its place.
6. In paragraph (d)(1)(i), remove the last sentence and add a sentence in its place.
7. In paragraph (d)(1)(ii), add a sentence at the end of the paragraph.
8. Paragraph (d)(1)(iii) is revised.
9. In paragraph (d)(1)(iv), remove the language "*Example 7*" and add "*Example 8*" in its place, and remove "*Example 11*" and add "*Example 14*" in its place.
10. Revise paragraph (d)(1)(v).
11. Revise paragraphs (d)(2)(i) and (ii).
12. In paragraph (d)(2)(iv), last sentence, remove the language "*Example 4*" and add "*Examples 5* and *5A*" in its place.
13. Revise paragraph (d)(2)(v)(C).
14. Redesignate paragraph (d)(2)(v)(D) as paragraph (d)(2)(v)(F).
15. Add new paragraphs (d)(2)(v)(D) and (E).
16. Revise paragraph (d)(2)(vi).
17. In paragraph (d)(3), redesignate the examples as follows and add the following new examples:

| Redesignate | As | Add |
|---|---|---|
| *Example 12* | *Example 16* | |
| | | *Example 15* |
| *Examples 11* and *11A* | *Examples 14* and *14A* | |
| *Examples 10* and *10A* | *Examples 13* and *13A* | |
| *Example 9* | *Example 12* | |
| | | *Examples 10* and *11* |
| *Example 8* | *Example 9* | |
| *Examples 7*, *7A*, *7B*, and *7C* | *Examples 8*, *8A*, *8B*, and *8C* | |
| *Examples 6* and *6A* | *Examples 7* and *7A* | |
| *Examples 5*, *5A*, and *5B* | *Examples 6*, *6A*, and *6B* | |
| | | *Examples 6C* and *6D* |
| *Example 4* | *Example 5* | |
| | | *Example 5A* |

| Redesignate | As | Add |
|---|---|---|
| *Example 3* | *Example 4* | |
| *Example 2* | *Example 3* | |
| | | *Example 2* |

18. In paragraph (d)(3), newly designated *Example 6A*, paragraph (i), the first and last sentences are revised.

19. In paragraph (d)(3), newly designated *Example 6B* and *Example 9* are revised.

20. In paragraph (d)(3), for each of the newly designated examples listed in the first column, replace the language in the second column with the language in the third column:

| Redesignated Examples | Remove | Add |
|---|---|---|
| *Example 6A*, paragraph (i), first sentence | *Example 5* | *Example 6* |
| *Example 7*, paragraph (i) | *Example 5* | *Example 6* |
| *Example 7A*, paragraph (i) and paragraph (ii), penultimate sentence | *Example 6* | *Example 7* |
| *Example 8*, paragraph (i) | *Example 5* | *Example 6* |
| *Example 8A*, paragraph (i) | *Example 7* | *Example 8* |
| *Example 8B*, paragraph (i) | *Example 7* | *Example 8* |
| *Example 8C*, paragraph (i) | *Example 7* | *Example 8* |
| *Example 12*, paragraph (i), third sentence | *Example 9* | *Example 12* |
| *Example 13A*, paragraph (i) and paragraph (ii), first sentence | *Example 10* | *Example 13* |
| *Example 14A*, paragraph (i) | *Example 11* | *Example 14* |

22. In paragraph (e)(1), remove the first sentence and add two sentences in its place.

The revisions and additions are as follows:

*§1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.*

* * * * *

(a) * * * However, if, in an exchange described in section 354 or 356, a U.S. person exchanges stock of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock of a domestic or foreign corporation for stock of a foreign corporation pursuant to an asset reorganization that is not treated as an indirect stock transfer under paragraph (d) of this section, such section 354 or 356 exchange is not a transfer to a foreign corporation subject to section 367(a). See paragraph (d)(3), *Example 16*, of this section. For purposes of this section, an asset reorganization is defined as a reorganization described in section 368(a)(1) involving a transfer of assets under section 361. If, in a transfer described in section 361, a domestic merging corporation transfers stock of a controlling corporation to a foreign surviving corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), such section 361 transfer is not subject to section 367(a) if the stock of the controlling corporation is provided to the merging corporation by the controlling corporation pursuant to the plan of reorganization; a section 361 transfer of other property, including stock of the controlling corporation not provided by the controlling corporation pursuant to the plan of reorganization, by the domestic merging corporation to the foreign surviving corporation pursuant to such a reorganization is subject to section 367(a). For special basis and holding period rules involving foreign corporations that are parties to certain reorganizations under section 368(a)(1), see §1.367(b)–13.* * *

(b) * * *

(2) * * *

(i) *In general.* A transfer of foreign stock or securities described in section 367(a) and the regulations thereunder as well as in section 367(b) and the regulations thereunder shall be subject concurrently to sections 367(a) and (b) and the regulations thereunder, except as provided in paragraph (b)(2)(i)(A) or (B) of this section. See paragraph (d)(3), *Example 11*, of this section.

(A) If a foreign corporation transfers assets to a domestic corporation in a transaction to which §1.367(b)–3(a) and (b) and the indirect stock transfer rules of paragraph (d) of this section apply, then the section 367(b) rules shall apply prior to the section 367(a) rules. See paragraph (d)(3), *Example 15*, of this section. This paragraph (b)(2)(i)(A) applies only to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

(B) Except as provided in paragraph (b)(2)(i)(A) of this section, section 367(b) and the regulations thereunder shall not apply if the foreign corporation is not treated

as a corporation under section 367(a)(1). See paragraph (d)(3), *Example 14*, of this section.

* * * * *

(c) * * *

(5) * * *

(vi) *Transferee foreign corporation*. Except as provided in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

* * * * *

(d) * * *

(1) * * * For examples of the concurrent application of the indirect stock transfer rules under section 367(a) and the rules of section 367(b), see paragraph (d)(3), *Examples 14* and *15* of this section. For purposes of this paragraph (d), if a corporation acquiring assets in a reorganization described in section 368(a)(1) transfers all or a portion of such assets to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation as part of the same transaction, the subsequent transfer of assets to the controlled corporation will be referred to as a controlled asset transfer. See section 368(a)(2)(C).

(i) * * * See paragraph (d)(3), *Example 1* of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) involving domestic acquired and acquiring corporations, and see paragraph (d)(3), *Example 10* of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(ii) * * * See paragraph (d)(3), *Example 2* of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) involving domestic acquired and acquiring corporations, and see paragraph (d)(3), *Example 11* of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(iii) *Triangular reorganizations described in section 368(a)(1)(B)*—(A) A U.S. person exchanges stock of the acquired corporation for voting stock of a foreign corporation that is in control (as defined in section 368(c)) of the acquiring corporation in a reorganization described in section 368(a)(1)(B). See paragraph (d)(3), *Example 5* of this section.

(B) A U.S. person exchanges stock of the acquired corporation for voting stock of a domestic corporation that is in control (as defined in section 368(c)) of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(B).

(*1*) For purposes of paragraphs (b) and (c) of this section, the foreign acquiring corporation is considered to be the transferee foreign corporation even though the U.S. transferor receives stock of the domestic controlling corporation in the exchange.

(*2*) If stock of a foreign acquired corporation is exchanged for the voting stock of a domestic corporation in control of a foreign acquiring corporation, then the exchange will be subject to the rules of paragraph (b) of this section. If the exchanging shareholder is a section 1248 shareholder with respect to the foreign acquired corporation, the indirect transfer will be subject to sections 367(a) and (b) concurrently. For the application of section 367(b) to the exchange, see §§1.367(b)–4 and 1.367(b)–13(c).

(*3*) If stock of a domestic acquired corporation is exchanged for the voting stock of a domestic corporation in control of a foreign acquiring corporation, then the exchange will be subject to the rules of paragraph (c) of this section.

(*4*) For purposes of applying the gain recognition agreement provisions of paragraph (d)(2) of this section and §1.367(a)–8, the domestic controlling corporation will be treated as the transferee foreign corporation. Thus, a disposition of foreign acquiring corporation stock by the domestic controlling corporation, or a disposition of acquired corporation stock by the foreign acquiring corporation, will trigger the gain recognition agreement. See paragraph (d)(3), *Example 5A* of this section.

(*5*) This paragraph (d)(1)(iii)(B) applies only to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(v) *Transfers of assets to subsidiaries in certain section 368(a)(1) reorganizations*. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign acquiring corporation in an asset reorganization (other than a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(iv) of this section or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (a)(2)(E) described in paragraphs (d)(1)(i) or (ii) of this section) that is followed by a controlled asset transfer. In the case of a transaction described in this paragraph (d)(1)(v) in which some but not all of the assets of the acquired corporation are transferred in a controlled asset transfer, the transaction shall be considered to be an indirect transfer of stock or securities subject to this paragraph (d) only to the extent of the assets so transferred. The remaining assets shall be treated as having been transferred in an asset transfer rather than an indirect stock transfer, and such asset transfer shall be subject to the other provisions of section 367, including sections 367(a)(1), (3), and (5), and (d) if the acquired corporation is a domestic corporation. See paragraph (d)(3), *Examples 6A* and *6B* of this section.

* * * * *

(2) * * *

(i) *Transferee foreign corporation*. Except as provided in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

(ii) *Transferred corporation*. The transferred corporation shall be the acquiring corporation, except as provided in this paragraph (d)(2)(ii). In the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii) of this section, the transferred corporation shall be the acquired corporation. In the case of an indirect stock transfer described in paragraph (d)(1)(i), (ii), or (iv) of this section followed by a controlled asset transfer, or an indirect stock transfer described in paragraph (d)(1)(v) of this section, the transferred corporation shall be the controlled corporation to which the assets are transferred. In the case of successive section 351 transfers described in paragraph (d)(1)(vi) of this section, the transferred corporation shall be the corporation to which the assets are transferred in the final section 351 transfer. The transferred property shall be the stock or securities of the transferred corporation, as appropriate under the circumstances.

* * * * *

(v) * * *

(C) In the case of an asset reorganization followed by a controlled asset transfer, as described in paragraph (d)(1)(v) of this section, the assets of the acquired corporation that are transferred to the corporation controlled by the acquiring corporation;

(D) In the case of a triangular reorganization described in section 368(a)(1)(C) followed by a controlled asset transfer, or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) followed by a controlled asset transfer, the assets of the acquired corporation including those transferred to the corporation controlled by the acquiring corporation;

(E) In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) followed by a controlled asset transfer, the assets of the acquiring corporation including those transferred to the corporation controlled by the acquiring corporation; and

* * * * *

(vi) *Coordination between asset transfer rules and indirect stock transfer rules*—(A) *General rule*. If, pursuant to any of the transactions described in paragraph (d)(1) of this section, a U.S. person transfers (or is deemed to transfer) assets to a foreign corporation in an exchange described in section 351 or 361, the rules of section 367, including sections 367(a)(1), (a)(3), and (a)(5), as well as section 367(d), and the regulations thereunder shall apply prior to the application of the rules of this section.

(B) *Exceptions*. (*1*) If a transaction is described in paragraph (d)(2)(vi)(A) of this section, sections 367(a) and (d) shall not apply to the extent a domestic corporation (domestic acquired corporation) transfers its assets to a foreign corporation (foreign acquiring corporation) in an asset reorganization, and such assets (re-transferred assets) are transferred to a domestic corporation (domestic controlled corporation) controlled (within the meaning of section 368(c)) by the foreign acquiring corporation as part of the same transaction, provided that the domestic controlled corporation's basis in such assets is no greater than the basis that the domestic acquired corporation had in such assets and the conditions contained in either of the following paragraphs are satisfied:

(*i*) The domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions as provided in regulations under section 367(a)(5) are satisfied. For purposes of determining whether the domestic acquired corporation is controlled by 5 or fewer domestic corporations, all members of the same affiliated group within the meaning of section 1504 shall be treated as 1 corporation.

(*ii*) The requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section are satisfied with respect to the indirect transfer of stock in the domestic acquired corporation, and the domestic acquired corporation attaches a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer.

(*2*) Sections 367(a) and (d) shall not apply to transfers described in paragraph (d)(1)(vi) of this section where a U.S. person transfers assets to a foreign corporation in a section 351 exchange, to the extent that such assets are transferred by such foreign corporation to a domestic corporation in another section 351 exchange, but only if the domestic transferee's basis in the assets is no greater than the basis that the U.S. transferor had in such assets.

(C) *Required statement*. The statement required by paragraph (d)(2)(vi)(B)(*1*)(*ii*) of this section shall be entitled "Required Statement under §1.367(a)–3(d) for Assets Transferred to a Domestic Corporation" and shall be signed under penalties of perjury by an authorized officer of the domestic acquired corporation and by an authorized officer of the foreign acquiring corporation. The required statement shall contain a certification that, if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation in a transaction described in paragraph (d)(2)(vi)(D) of this section, the domestic acquired corporation shall recognize gain as described in paragraph (d)(2)(vi)(E)(*1*) of this section. The domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) shall file a U.S. income tax return (or an amended U.S. tax return, as the case may be) for the year of the transfer reporting such gain.

(D) *Gain recognition transaction* . (*1*) A transaction described in this paragraph (d)(2)(vi)(D) is one where a principal purpose of the transfer by the domestic acquired corporation is the avoidance of U.S. tax that would have been imposed on the domestic acquired corporation on the disposition of the re-transferred assets. A transfer may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together.

(*2*) For purposes of paragraph (d)(2)(vi)(D)(*1*) of this section, a transaction is deemed to have a principal purpose of tax avoidance if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation (whether in a recognition or non-recognition transaction) within 2 years of the transfer. The rule in this paragraph (d)(2)(vi)(D)(*2*) shall not apply if the domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) demonstrates to the satisfaction of the Commissioner that the avoidance of U.S. tax was not a principal purpose of the transaction.

(E) *Amount of gain recognized and other matters*. (*1*) In the case of a transaction described in paragraph (d)(2)(vi)(D) of this section, solely for purposes of this paragraph (d)(2)(vi)(E), the domestic acquired corporation shall be treated as if, immediately prior to the transfer, it transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of such domestic corporation in a transaction that is treated as a section 351 exchange, and immediately sold such stock to an unrelated party for its fair market value in a sale in which it shall recognize gain, if any (but not loss). Any gain recognized by the domestic acquired corporation pursuant to this paragraph (d)(2)(vi)(E) will increase the basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation immediately before the transaction described in paragraph (d)(2)(vi)(D) of this section, but will not increase the basis of the re-transferred assets held by the domestic controlled corporation. Section 1.367(d)–1T(g)(6) shall not apply with respect to any intangible

property included in the re-transferred assets described in the preceding sentence.

(*2*) If additional tax is required to be paid as a result of a transaction described in paragraph (d)(2)(vi)(D) of this section, then interest must be paid on that amount at rates determined under section 6621 with respect to the period between the date prescribed for filing the domestic acquired corporation's income tax return for the year of the transfer and the date on which the additional tax for that year is paid.

(F) *Examples*. For illustrations of the rules in paragraph (d)(2)(vi) of this section, see paragraph (d)(3), *Examples 6B*, *6C*, *6D*, *9*, and *13A* of this section.

(G) *Effective dates*. Paragraph (d)(2)(vi) of this section applies only to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. See §1.367(a)–3(d)(2)(vi), as contained in 26 CFR Part 1 revised as of April 1, 2004, for transactions occurring on or after July 20, 1998, until the date these regulations are published as final regulations in the **Federal Register**.

(3) * * *

*Example 2. Section 368(a)(1)(A)/(a)(2)(E) reorganization*—(i) *Facts*. The facts are the same as in *Example 1*, except that Newco merges into W and Newco receives stock of W which it distributes to F in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, A receives 40 percent of the stock of F in an exchange described in section 354.

(ii) *Result*. The consequences of the transfer are similar to those described in *Example 1*. Pursuant to paragraph (d)(1)(ii) of this section, the reorganization is subject to the indirect stock transfer rules. F is treated as the transferee foreign corporation, and W is treated as the transferred corporation. Provided that the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that A enter into a five-year gain recognition agreement as described in §1.367(a)–8, A's exchange of W stock for F stock under section 354 will not be subject to section 367(a)(1).

* * * * *

*Example 5A. Triangular section 368(a)(1)(B) reorganization*—(i) *Facts*. The facts are the same as in *Example 5*, except that F is a domestic corporation and S is a foreign corporation.

(ii) *Result*. U's exchange of Y stock for stock of F, a domestic corporation in control of S, the foreign acquiring corporation, is treated as an indirect transfer of Y stock to a foreign corporation under paragraph (d)(1)(iii) of this section. U's exchange of Y stock for F stock will not be subject to section 367(a)(1) provided that all of the requirements of paragraph (c)(1) are satisfied, including the requirement that U enter in a five-year gain recognition agreement. In satisfying the 50 percent or less ownership requirements of paragraph (c)(1)(i) and (ii) of this section, U's indirect ownership of S stock (through its direct ownership of F stock) will determine whether the requirement of paragraph (c)(1)(i) is satisfied and will be taken into account in determining whether the requirement of paragraph (c)(1)(ii) is satisfied. See paragraph (c)(4)(iv)). For purposes of applying the gain recognition agreement provisions of paragraph (d)(2) of this section and §1.367(a)–8, F is treated as the transferee foreign corporation. The gain recognition agreement would be triggered if F sold all or a portion of the stock of S, or if S sold all or a portion of the stock of Y.

* * * * *

*Example 6A. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer*—(i) *Facts*. The facts are the same as in *Example 6*, except that the transaction is structured as a section 368(a)(1)(C) reorganization, followed by a controlled asset transfer, and R is a foreign corporation. * * * F then contributes Businesses B and C to R in a controlled asset transfer. * * *

* * * * *

*Example 6B. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation*—(i) *Facts*. The facts are the same as in *Example 6A*, except that R is a domestic corporation.

(ii) *Result*. As in *Example 6A*, the outbound transfer of the Business A assets to F is not affected by the rules of this paragraph (d) and is subject to the general rules under section 367. However, the Business A assets qualify for the section 367(a)(3) active trade or business exception. The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under sections 367(a) and (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3); the Business C assets do not. However, pursuant to paragraph (d)(2)(vi)(B) of this section, the Business C assets are not subject to section 367(a) or (d), provided that the basis of the Business C assets in the hands of R is no greater than the basis of the assets in the hands of Z, and appropriate basis adjustments are made pursuant to section 367(a)(5) to the stock of F held by V. (In this case, no adjustments are required because, pursuant to section 358, V takes a basis of $30 in the stock of F, which is equal to V's proportionate share of the basis in the assets of Z ($30) transferred to F.) V also is deemed to make an indirect transfer of stock under the rules of paragraph (d). To preserve non-recognition treatment under section 367(a), V must enter into a 5-year gain recognition agreement in the amount of $50, the amount of the appreciation in the Business B and C assets, as the transfer of such assets by Z was not taxable under section 367(a)(1) and constituted an indirect stock transfer.

*Example 6C. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation*—(i) *Facts*. The facts are the same as in *Example 6B*, except that Z is owned by individuals, none of whom qualify as five-percent target shareholders with respect to Z within the meaning of paragraph (c)(5)(iii) of this section. The following additional facts are present. No U.S. persons that are either officers or directors of Z own any stock of F immediately after the transfer. F is engaged in an active trade or business outside the United States that satisfies the test set forth in paragraph (c)(3) of this section.

(ii) *Result*. The transfer of the Business A assets is not affected by the rules of this paragraph (d). However, the transfer of such assets is subject to gain recognition under section 367(a)(1), because the section 367(a)(3) active trade or business exception is inapplicable pursuant to section 367(a)(5). The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under sections 367(a) and (d). The transfer of the Business B assets (which otherwise would satisfy the section 367(a)(3) active trade or business exception) generally is subject to section 367(a)(1) pursuant to section 367(a)(5). The transfer of the Business C assets generally is subject to sections 367(a)(1) and (d). However, pursuant to paragraph (d)(2)(vi)(B) of this section, the transfer of the Business B and C assets is not subject to sections 367(a)(1) and (d), provided the basis of the Business B and C assets in the hands of R is no greater than the basis in the hands of Z and certain other requirements are satisfied. Since Z is not controlled within the meaning of section 368(c) by 5 or fewer domestic corporations, the indirect transfer of Z stock must satisfy the requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section, and Z must attach a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer. In general, the statement must contain a certification that, if F disposes of the stock of R (in a recognition or nonrecognition transaction) and a principal purpose of the transfer is the avoidance of U.S. tax that would have been imposed on Z on the disposition of the Business B and C assets transferred to R, then Z (or F on behalf of Z) will file a return (or amended return as the case may be) recognizing gain ($50), as if, immediately prior to the reorganization, Z transferred the Business B and C assets to a domestic corporation in exchange for stock in a transaction treated as a section 351 exchange and immediately sold such stock to an unrelated party for its fair market value. A transaction is deemed to have a principal purpose of U.S. tax avoidance if F disposes of R stock within two years of the transfer, unless Z (or F on behalf of Z) can rebut the presumption to the satisfaction of the Commissioner. See paragraph (d)(2)(vi)(D)(*2*) of this section. With respect to the indirect transfer of Z stock, the requirements of paragraphs (c)(1)(i), (ii), and (iv) of this section are satisfied. Thus, assuming Z attaches the statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return and satisfies the reporting requirements of (c)(6) of this section, the transfer of Business B and C assets is not subject to section 367(a) or (d).

*Example 6D. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation*—(i) *Facts*. The facts are the same as in *Example 6C*, except that the Z shareholders receive 60 percent of the F stock in exchange for their Z stock in the reorganization.

(ii) *Result*. The requirement of paragraph (c)(1)(i) of this section is not satisfied because the Z shareholders that are U.S. persons do not receive 50 percent or less of the total voting power and the total value of the stock of F in the transaction. Accordingly, Z shareholders that are U.S. persons are subject to section 367(a)(1) on their exchange of Z stock for F stock pursuant to the reorganization.

For the same reason, the conditions of paragraph (d)(2)(vi)(B)(*1*)(*ii*) of this section are not met. Accordingly, the transfer of Business B and C assets is subject to sections 367(a)(1) and (d), even though such assets are re-transferred to R, a domestic corporation. As in *Example 6C*, the transfer of Business A assets, which is not affected by the rules of paragraph (d) of this section, is subject to gain recognition under sections 367(a)(1) and (5).

* * * * *

*Example 9. Concurrent application with a controlled asset transfer*—(i) *Facts*. The facts are the same as in *Example 8*, except that R transfers the Business A assets to M, a wholly owned domestic subsidiary of R, in a controlled asset transfer. In addition, V's basis in its Z stock is $90.

(ii) *Result*. Pursuant to paragraph (d)(2)(vi)(B) of this section, sections 367(a) and (d) do not apply to Z's transfer of the Business A assets to R, because such assets are re-transferred to M, a domestic corporation, provided that the basis of the Business A assets in the hands of M is no greater than the basis of the assets in the hands of Z, and certain other requirements are satisfied. Because Z is controlled (within the meaning of section 368(c)) by V, a domestic corporation, appropriate basis adjustments must be made pursuant to section 367(a)(5) to the stock of F held by V. (In this case, no adjustments are required because, pursuant to section 358, V takes a basis of $90 in the stock of F, which is less than V's proportionate share of the basis in the assets of Z ($100) transferred to R.) Section 367(a)(1) does not apply to Z's transfer of its Business B assets to R (which are not re-transferred to M) because such assets qualify for an exception to gain recognition under section 367(a)(3). With respect to the indirect transfer of Z stock, such transfer is not subject to gain recognition under section 367(a)(1) if the requirements of paragraph (c) of this section are satisfied, including the requirement that V enter into a 5-year gain recognition agreement and comply with the requirements of §1.367(a)–8 with respect to the gain ($100) realized on the Z stock. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F and the transferred corporation is M. Pursuant to paragraph (d)(2)(iv) of this section, a disposition by F of the stock of R, or a disposition by R of the stock of M, will trigger the gain recognition agreement. To determine whether an asset disposition constitutes a deemed disposition of the transferred corporation's stock under the rules of §1.367(a)–8(e)(3)(i), both the Business A assets in M and the Business B assets in R must be considered.

*Example 10. Concurrent application in section 368(a)(1)(A)/(a)(2)(D) reorganization*—(i) *Facts*. The facts are the same as in *Example 8*, except that R acquires all of the assets of Z in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, V receives 30 percent of the stock of F in a section 354 exchange.

(ii) *Result*. The consequences of the transaction are similar to those in *Example 8*. The assets of Businesses A and B that are transferred to R must be tested under section 367(a) prior to the consideration of the indirect stock transfer rules of this paragraph (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3). Because the Business A assets do not qualify for the exception, Z must recognize $40 of gain under section 367(a) on the transfer of Business A assets to R. Because V and Z file a consolidated return, V's basis in the stock of Z is increased from $100 to $140 as a result of Z's $40 gain. V's indirect transfer of Z stock will be taxable under section 367(a) unless V enters into a gain recognition agreement in the amount of $60 ($200 value of Z stock less $140 adjusted basis) and the other requirements of paragraph (c)(1) of this section are satisfied.

*Example 11. Section 368(a)(1)(A)/(a)(2)(E) reorganization*—(i) *Facts*. F, a foreign corporation, owns all the stock of D, a domestic corporation. V, a domestic corporation, owns all the stock of Z, a foreign corporation. V has a basis of $100 in the stock of Z which has a fair market value of $200. D is an operating corporation with assets valued at $100 with a basis of $60. In a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), D merges into Z, and V exchanges its Z stock for 55 percent of the outstanding F stock.

(ii) *Result*. Under paragraph (d)(1)(ii) of this section, V is treated as making an indirect transfer of Z stock to F. V's exchange of Z stock for F stock will be taxable under section 367(a) (and section 1248 will be applicable) if V fails to enter into a 5-year gain recognition agreement in accordance with the requirements of §1.367(a)–8. Under paragraph (b)(2) of this section, if V enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder as well as section 367(a). Under §1.367(b)–4(b) of this chapter, however, no income inclusion is required because both F and Z are controlled foreign corporations with respect to which V is a section 1248 shareholder immediately after the exchange. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F, and the transferred corporation is Z (the acquiring corporation). If F disposes (within the meaning of §1.367(a)–8(e)) of all (or a portion) of Z stock within the 5-year term of the agreement (and V has not made a valid election under §1.367(a)–8(b)(1)(vii)), V is required to file an amended return for the year of the transfer and include in income, with interest, the gain realized but not recognized on the initial section 354 exchange. To determine whether Z (the transferred corporation) disposes of substantially all of its assets, the assets of Z immediately prior to the transaction are taken into account, pursuant to paragraph (d)(2)(v)(B) of this section. Because D is owned by F, a foreign corporation, section 367(a)(5) precludes any assets of D from qualifying for nonrecognition under section 367(a)(3). Thus, D recognizes $40 of gain on the transfer of its assets to Z under section 367(a)(1).

* * * * *

*Example 15. Concurrent application of indirect stock transfer rules and section 367(b)*— (i) *Facts*. F, a foreign corporation, owns all of the stock of Newco, a domestic corporation. P, a domestic corporation, owns all of the stock of FC, a foreign corporation. P's basis in the stock of FC is $50 and the value of FC stock is $100. The all earnings and profits amount with respect to the FC stock held by P is $60. See §1.367(b)–2(d). In a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) (and paragraph (d)(1)(i) of this section), Newco acquires all of the properties of FC, and P exchanges its stock in FC for 20 percent of the stock in F.

(ii) *Result*. Because a domestic corporation, Newco, acquires the assets of a foreign corporation, FC, in an asset reorganization to which §1.367(b)–3(a) and (b) and the indirect stock rules of paragraph (d) of this section apply, the section 367(b) rules apply before the section 367(a) rules apply. See §1.367(a)–3(b)(2)(i)(A). Under the rules of section 367(b), P must include in income the all earnings and profits amount of $60 with respect to its FC stock. See §1.367(b)–3. Although P's exchange of FC stock for F stock under section 354 is an indirect stock transfer, no gain is recognized under section 367(a), because P's basis in the FC stock is increased by the amount ($60) included in income under the rules of section 367(b). See §1.367(b)–2(e)(3)(ii). Alternatively, if P's all earnings and profits amount were $30, then the amount of the income inclusion and basis adjustment under the rules of section 367(b) would be $30, and the amount of gain subject to section 367(a)(1) would be $20 unless P entered into a 5-year gain recognition agreement in accordance with §1.367(a)–8.

* * * * *

(e) * * *

(1) *In general*. Except as provided in paragraphs (b)(2)(i)(A), (d)(1)(iii)(B), and (d)(2)(vi)(G), or in this paragraph (e), the rules in paragraphs (a), (b), and (d) of this section apply to transfers occurring on or after July 20, 1998. The rules in paragraphs (a) and (d) of this section, as they apply to section 368(a)(1)(A) reorganizations (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or acquired corporation, apply only to transfers occurring after the date these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

Par. 5. Section 1.367(a)–8 is amended as follows:

1. In paragraphs (c)(2) and (d), remove the words "district director" and add "Director of Field Operations" in their place.

2. In paragraph (e)(1)(i), a sentence is added after the first sentence.

The addition reads as follows:

*§1.367(a)–8 Gain recognition agreement requirements.*

* * * * *

(e) * * *

(1) * * *

(i) * * * It also includes an indirect disposition of the stock of the transferred corporation as described in §1.367(a)–3(d)(2)(iv). * * *

* * * * *

Par. 6. In §1.367(b)–1(a), remove the third and fourth sentences and add a sentence in their place to read as follows:

*§1.367(b)–1 Other transfers.*

(a) * * * For rules coordinating the concurrent application of sections 367(a) and (b), including the extent to which section 367(b) does not apply if the foreign corporation is not treated as a corporation under section 367(a), see §1.367(a)–3(b)(2)(i). * * *

* * * * *

Par. 7. In §1.367(b)–3(b)(3)(ii), revise paragraph (i) of *Example 5* to read as follows:

*§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.*

* * * * *

(b) * * *

(3) * * *

(ii) * * *

*Example 5*—(i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC2, a foreign corporation. The all earnings and profits amount with respect to the FC2 stock owned by FC1 is $20. In a reorganization described in section 368(a)(1)(A), DC2, a domestic corporation unrelated to FC1 or FC2, acquires all of the assets and liabilities of FC2 pursuant to a State W merger. FC2 receives DC2 stock and distributes such stock to FC1. The FC2 stock held by FC1 is canceled, and FC2 ceases its separate legal existence.

* * * * *

Par. 8. Section 1.367(b)–4 is amended as follows.

1. Paragraph (a) is revised.

2. Redesignate paragraph (b)(1)(ii) as paragraph (b)(1)(iii), and add new paragraph (b)(1)(ii).

3. In newly designated paragraph (b)(1)(iii), after *Example 3*, add *Examples 3A* and *3B*.

The revisions and additions read as follows:

*§1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.*

(a) *Scope*. This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of the stock or assets of a foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1). In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), this section applies if stock of the foreign surviving corporation is exchanged for stock of a foreign corporation in control of the merging corporation; in such a case, the foreign surviving corporation is treated as a foreign acquired corporation for purposes of this section. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as both the foreign acquired corporation and foreign acquiring corporation for purposes of this section. See §1.367(a)–3(b)(2) for transactions subject to the concurrent application of this section and section 367(a).

(b) * * *

(1) * * *

(ii) *Exception*. In the case of a triangular reorganization described in section 368(a)(1)(B) or (C), or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E), an exchange is not described in paragraph (b)(1)(i) of this section if the stock received in the exchange is stock of a domestic corporation and, immediately after the exchange, such domestic corporation is a section 1248 shareholder of the acquired corporation (in the case of a triangular section 368(a)(1)(B) reorganization) or the surviving corporation (in the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E)) and such acquired or surviving corporation is a controlled foreign corporation. See paragraph (b)(1)(iii) of this section, *Example 3B* for an illustration of this rule.

(iii) * * *

*Example 3A*. (i) *Facts*. The facts are the same as in *Example 3*, except that FC1 merges into FC2 in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, DC exchanges its FC2 stock for stock of FP.

(ii) *Result*. The result is similar to the result in *Example 3*. The transfer is an indirect stock transfer subject to section 367(a). See §1.367(a)–3(d)(1)(ii). Accordingly, DC's exchange of FC2 stock for FP stock will be taxable under section 367(a) (and section 1248 will be applicable) if DC fails to enter into a gain recognition agreement. If DC enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder, as well as section 367(a). If FP and FC2 are controlled foreign corporations as to which DC is a (direct or indirect) section 1248 shareholder immediately after the reorganization, then paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount and the amount of the gain recognition agreement is the amount of gain realized on the indirect stock transfer. If FP or FC2 is not a controlled foreign corporation as to which DC is a (direct or indirect) section 1248 shareholder immediately after the exchange, then DC must include in income the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged. Under these circumstances, the gain recognition agreement would be the amount of gain realized on the indirect transfer, less the $20 section 1248 income inclusion.

*Example 3B*. (i) *Facts*. The facts are the same as *Example 3*, except that USP, a domestic corporation, owns the controlling interest (within the meaning of section 368(c)) in FC1 stock. FC2 merges into FC1 in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, DC exchanges its FC2 stock for USP stock.

(ii) *Result*. Because DC receives stock of a domestic corporation, USP, in the section 354 exchange, the transfer is not an indirect stock transfer subject to section 367(a). Accordingly, the exchange will be subject only to the provisions of section 367(b) and the regulations thereunder. Under paragraph (b)(1)(ii)(A) of this section, because the stock received is stock of a domestic corporation (USP) and, immediately after the exchange, USP is a section 1248 shareholder of FC1 (the acquiring corporation) and FC1 is a controlled foreign corporation, the exchange is not described in paragraph (b)(1)(i) of this section and DC includes no amount in its gross income. See §1.367(b)–13(b) and (c) for the basis and holding period rules applicable to this transaction, which cause USP's adjusted basis and holding period in the stock of FC1 after the transaction to reflect the basis and holding period that DC had in its FC2 stock.

* * * * *

Par. 9. In §1.367(b)–6, paragraph (a)(1), add a sentence to the end to read as follows:

*§1.367(b)–6 Effective dates and coordination rules.*

(a) * * *

(1) * * * The rules of §§1.367(b)–3 and 1.367(b)–4, as they apply to reorganizations described in section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or foreign acquired corporation, apply only to transfers occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 10. Section 1.367(b)–13 is added to read as follows:

*§1.367(b)–13 Special rules for determining basis and holding period.*

(a) *Scope and definitions*—(1) *Scope*. This section provides special basis and holding period rules for certain transactions involving the acquisition of property by a foreign acquiring corporation in nonrecognition exchanges. Special rules apply to determine the basis and holding period of stock in a foreign corporation received by certain shareholders in a section 354 or 356 exchange. In addition, special rules apply to determine the basis and holding period of stock of certain foreign surviving corporations held by a controlling corporation whose stock is issued in an exchange under section 354 or 356 in a triangular reorganization. This section applies to transactions that are subject to section 367(b) as well as section 367(a), including transactions concurrently subject to sections 367(a) and (b).

(2) *Definitions*. For purposes of this section, the following definitions apply:

(i) A foreign acquired corporation is a foreign corporation whose stock or assets are acquired by a foreign corporation in a reorganization described in section 368(a)(1). In a reverse triangular merger, where T is a foreign corporation, T is treated as a foreign acquired corporation. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as a foreign acquired corporation.

(ii) A block of stock has the meaning provided in §1.1248–2(b).

(iii) A triangular reorganization is a reorganization described in §1.358–6(b)(2)(i), (ii), or (iii) (but not a reorganization described in §1.358–6(b)(2)(iv)). A triangular C reorganization, a forward triangular merger, and a reverse triangular merger each is a reorganization described in §1.358–6(b)(2)(i), (ii), or (iii), respectively. For purposes of triangular reorganizations—

(A) P is a corporation that is a party to a reorganization that is in control (within the meaning of section 368(c)) of another party to the reorganization and whose stock is transferred pursuant to the reorganization;

(B) S is a corporation that is a party to the reorganization and that is controlled by P; and

(C) T is a corporation that is another party to the reorganization.

(b) *Determination of basis and holding period for exchanges of foreign stock*—(1) *Application*. Except as provided in paragraph (b)(4) of this section, this paragraph (b) applies to a shareholder that exchanges stock of a foreign acquired corporation in an exchange under section 354 or 356 for stock of a controlled foreign corporation, if—

(i) Immediately before the exchange either such shareholder is a section 1248 shareholder with respect to the foreign acquired corporation, or such shareholder is a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and the foreign acquired corporation; and

(ii) The exchange is not described in §1.367(b)–4(b)(1)(i), (2)(i), or (3).

(2) *Basis and holding period rules*—(i) If a shareholder surrenders a share of stock in an exchange under the terms of section 354 or 356, the basis and holding period of each share of stock received in the exchange shall be the same as the basis and holding period of the allocable portion of the share or shares of stock exchanged therefor, as adjusted under §1.358–1 (such that the section 1248 amount of each share of stock exchanged is preserved in the share or shares of stock received). If more than one share of stock is received in exchange for one share of stock, the basis of the share of stock surrendered shall be allocated to the shares of stock received in the exchange in proportion to the fair market value of the shares of stock received. If one share of stock is received in respect of more than one share of stock or a fraction of a share of stock is received, the basis of the shares of stock surrendered must be allocated to the share of stock received, or a fraction thereof received, in a manner that reflects, to the greatest extent possible, that a share of stock is received in respect of shares of stock acquired on the same date and at the same price. The provisions of this paragraph may be applied, to the extent possible, on the basis of blocks of stock.

(ii) If a shareholder that purchased or acquired shares of stock in a corporation on different dates or at different prices exchanges such shares of stock under the terms of section 354 or 356, and the shareholder is not able to identify which particular share or shares of stock (or portion of a share of stock) is received in exchange for a particular share or shares of stock, the shareholder may designate which share or shares of stock is received in exchange for a particular share or shares of stock, provided that such designation is consistent with the terms of the exchange or distribution. The designation must be made on or before the first date on which the basis of a share of stock received is relevant. The basis of a share received, for example, is relevant when such share is sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of a share received. If the shareholder fails to make a designation, then the shareholder will not be able to identify which share is sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012–1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired. See paragraph (e), *Example 1* of this section for an illustration of this paragraph (b).

(3) In the case of a triangular reorganization, this paragraph (b) applies only to the exchange of T stock for P stock by T shareholders. See paragraph (c) of this section to determine the basis and holding period of stock of the surviving corporation (S or T) held by P immediately after a triangular reorganization.

(4) Paragraphs (b)(1) through (3) of this section shall not apply to determine the basis of a share of stock received by a shareholder in an exchange described in both section 351 and section 354 or 356, if, in connection with the exchange, the shareholder exchanges property for stock in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder are assumed.

(c) *Determination of basis and holding period for triangular reorganizations*—(1) *Application*. In the case of a triangular reorganization, this paragraph (c) applies, if—

(i) In the case of a reverse triangular merger—

(A) Immediately before the transaction, either P is a section 1248 shareholder with respect to S, or P is a foreign corporation and a United States person is a sec-

tion 1248 shareholder with respect to both P and S; and

(B) P's exchange of S stock is not described in §1.367(b)–3(a) and (b) or in §1.367(b)–4(b)(1)(i), (2)(i), or (3); or

(ii)(A) Immediately before the transaction, a shareholder of T is either a section 1248 shareholder with respect to T or a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and T; and

(B) With respect to at least one of the exchanging shareholders described in paragraph (c)(1)(ii)(A) of this section, the exchange of T stock is not described in §1.367(b)–3(a) and (b) or in §1.367(b)–4(b)(1)(i), (2)(i), or (3).

(2) *Basis and holding period rules*. In the case of a triangular reorganization described in this paragraph (c), each share of stock of the surviving corporation (S or T) held by P must be divided into portions attributable to the S stock and the T stock immediately before the exchange. See paragraph (e) of this section, *Examples 2* through *5* for illustrations of this rule.

(i) *Portions attributable to S stock*—(A) In the case of a forward triangular merger or a triangular C reorganization, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and holding period of such share of stock immediately before the exchange.

(B) In the case of a reverse triangular merger, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and the holding period immediately before the exchange of a proportionate amount of the S stock to which the portion relates. If P is a shareholder described in paragraph (c)(1)(i)(A) of this section with respect to S, and P exchanges two or more blocks of S stock pursuant to the transaction, then each share of the surviving corporation (T) attributable to the S stock must be further divided into separate portions to account for the separate blocks of stock in S.

(C) If the value of S stock immediately before the triangular reorganization is less than one percent of the value of the surviving corporation stock immediately after the triangular reorganization, then P may determine its basis in the surviving corporation stock by applying the rules of paragraph (c)(2)(ii) of this section to determine the basis and holding period of the surviving corporation stock attributable to the T stock, and then increasing the basis of each share of surviving corporation stock by the proportionate amount of P's aggregate basis in the S stock immediately before the exchange (without dividing the stock of the surviving corporation into separate portions attributable to the S stock).

(ii) *Portions attributable to T stock*—(A) If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the basis and holding period of the portion of each share of stock in the surviving corporation attributable to the T stock is the basis and holding period immediately before the exchange of a proportionate amount of the T stock to which such portion relates. If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, and such shareholder exchanges two or more blocks of T stock pursuant to the transaction, then each share of surviving corporation stock attributable to the T stock must be further divided into separate portions to account for the separate blocks of T stock.

(B) If no exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the rules of §1.358–6(c) apply to determine the basis of the portion of each share of the surviving corporation attributable to T immediately before the exchange.

(d) *Special rules applicable to divided shares of stock*—(1) *In general*—(i) Shares of stock in different blocks can be aggregated into one divided portion for basis purposes, if such shares immediately before the exchange are owned by one or more shareholders that are—

(A) Neither section 1248 shareholders with respect to the corporation nor foreign corporate shareholders; or

(B) Foreign corporate shareholders, provided that no United States persons are section 1248 shareholders with respect to both such foreign corporate shareholders and the corporation.

(ii) For purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion pursuant to paragraph (c) of this section, any amount realized on such sale or exchange will be allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created.

(iii) Shares of stock will no longer be required to be divided if section 1248 or section 964(e) would not apply to a disposition or exchange of such stock.

(2) *Pre-exchange earnings and profits*. All earnings and profits (or deficits) accumulated by a foreign corporation before the reorganization and attributable to a share (or block) of stock for purposes of section 1248 are attributable to the divided portion of stock with the basis and holding period of that share (or block). See §1.367(b)–4(d).

(3) *Post-exchange earnings and profits*. Any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits (or deficits) attributable to a divided share of stock is further attributed to the divided portions of such share of stock based on the relative fair market value of each divided portion of stock.

(e) *Examples*. The rules of this section are illustrated by the following examples:

*Example 1*. (i) *Facts*. US1 is a domestic corporation that owns all the stock of FT, a foreign corporation with 100 shares of stock outstanding. Each share of FT stock is valued at $10x. Because US1 acquired the stock of FT at two different dates, US1 owns two blocks of FT stock for purposes of section 1248. The first block consists of 60 shares. The shares in the first block have a basis of $300x ($5x per share), a holding period of 10 years, and $240x ($4x per share) of earnings and profits attributable to the shares for purposes of section 1248. The second block consists of 40 shares. The shares in the second block have a basis of $600x ($15x per share), a holding period of 2 years, and $80x ($2x per share) of earnings and profits attributable to the shares for purposes of section 1248. US2, a domestic corporation, owns all of the stock of FP, a foreign corporation, which owns all of the stock of FS, a foreign corporation. FT merges into FS with FS surviving in a reorganization described in section 368(a)(1)(A). Pursuant to the reorganization, US1 receives 50 shares of FS stock with a value of $1,000x for its FT stock in an exchange that qualifies for nonrecognition under section 354.

(ii) *Basis and holding period determination*—(A) US1 is a section 1248 shareholder of FT immediately before the exchange and exchanges its FT stock for stock of a controlled foreign corporation (FS) as to which US1 is a section 1248 shareholder immediately after the exchange. US1 is not required to include income under §1.367(b)–4(b) with respect to the exchange. Accordingly, the basis and holding period of the FS stock received by US1 is determined pursuant to paragraph (b) of this section.

(B) Pursuant to paragraph (b) of this section, 30 shares of the FS stock received by US1 in the reorganization (valued at $20x per share and exchanged for US1's first block of 60 shares of FT stock) have a basis of $300x ($10x per share), a holding period of 10 years, and $240x of earnings and profits ($8x per share) attributable to such shares for purposes of section 1248. In addition, 20 shares of the FS stock (valued at $20 per share and exchanged for US1's second block of 40 shares of FT stock) have a basis of $600x ($30x per share), a holding period of 2 years, and $80x of earnings and profits ($4x per share) attributable to such shares for purposes of section 1248.

(iii) *Subsequent Disposition*. Assume, subsequent to the exchange, US1 disposes of 20 shares of FS stock. On or before the date of the disposition when the basis of the F1 shares received by US1 becomes relevant, US1 can designate the 20 shares from the first block, the second block, or from any combination of shares in both blocks.

*Example 2*. (i) *Facts*. The facts are the same as in *Example 1*, except that US1 receives 50 shares of FP stock (instead of FS stock) with a value of $1,000x in exchange for its FT stock. Accordingly, the merger of FT into FS qualifies as forward triangular merger, and immediately after the exchange US1 is a section 1248 shareholder with respect to FP and FS. Additionally, prior to the transaction, FP owned two blocks of FS stock. Each block consisted of 10 shares with a value of $200x ($20x per share). The shares in the first block had a basis of $50x ($5x per share), a holding period of 10 years, and $50x ($5x per share) of earnings and profits attributable to such shares for purposes of section 1248. The shares in the second block had a basis of $100x ($10x per share), a holding period of 5 years, and $20x ($2x per share) of earnings and profits attributable to such shares for purposes of section 1248.

(ii) *Basis and holding period determination.* (A) The basis and holding period of the FP shares received by US1 in the exchange are determined pursuant to paragraph (b) of this section and are identical to the results in *Example 1*.

(B)(*1*) US1 is a section 1248 shareholder of FT immediately before the transaction. Moreover, US1 is not required to include income under §1.367(b)–3(b) or 1.367(b)–4(b) as described in paragraph (c)(2) of this section. Accordingly, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(*2*) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by US1 immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock in the first block has a portion with a basis of $5x, a value of $20x, a holding period of 10 years, and $5x of earnings and profits attributable to such portion for purposes of section 1248. Each share of FS stock in the second block has a portion with a basis of $10x, a value of $20x, a holding period of 5 years, and $2x of earnings and profits attributable to such portion for purposes of section 1248.

(*3*) Because the exchanging shareholder of FT stock (US1) is a section 1248 shareholder, the holding period and basis of the FT portion is the holding period and the proportionate amount of the basis of the FT stock immediately before the exchange to which such portion relates. Further, because US1 exchanged two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock. Thus, each share of FS stock will have a second portion with a basis of $15x ($300x basis / 20 shares), a value of $30x ($600x value / 20 shares), a holding period of 10 years, and $12x of earnings and profits ($240x / 20 shares) attributable to such portion for purposes of section 1248. Each share of FS stock will have a third portion with a basis of $30x ($600x basis / 20 shares), a value of $20x ($400x value / 20 shares), a holding period of 2 years, and $4x of earnings and profits ($80x / 20 shares) attributable to such portion for purposes of section 1248.

(iii) Assume, immediately after the transaction, FP disposes of a share of FS stock from the first block. When FP disposes of any share of its FS stock, it is treated as disposing of each divided portion of such share. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $15x ($20x value - $5x basis), $5x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

(iv) Assume further, immediately after the transaction, FP also disposes of a share of stock from the second block of FS stock. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $10x ($20x value - $10x basis), $2x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

*Example 2A*. (i) *Facts*. The facts are the same as in *Example 2*, except that FS merges into FT with FT surviving in a reverse triangular merger. Pursuant to the merger, US1 receives FP stock with a value of $1,000x in exchange for its FT stock, and FP receives 10 shares of FT stock with a value of $1,400x in exchange for its FS stock. Immediately after the exchange, US1 is a section 1248 shareholder with respect to FP and FT.

(ii) *Basis and holding period determination*—(A) The basis and holding period of the FP shares received by US1 and the stock of the surviving corporation held by FP are the same as in *Example 2*, except that each share of the surviving corporation (FT, instead of FS) will be divided into four portions instead of three portions. Because FP exchanges two blocks of FS stock, the FS portion must be divided into two separate portions attributable to the two blocks of FS stock. Because US1 exchanges two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock.

(B) Thus, each share of the surviving corporation (FT) will have a first portion (attributable to the first block of FS stock) with a basis of $5x ($50x / 10 shares), a value of $20x ($200x / 10 shares), a holding period of 10 years, and $5x of earnings and profits ($50x / 10 shares) attributable to such portion for purposes of section 1248. Each share of FT stock will have a second portion (attributable to the second block of FS stock) with a basis of $10x ($100x / 10 shares), a value of $20x ($200x / 10 shares), a holding period of 5 years, and $2x of earnings and profits ($20x / 10 shares) attributable to such portion for purposes of section 1248. Moreover, each share of FT stock will have a third portion (attributable to the first block of FT stock) with a basis of $30x ($300x basis / 10 shares), a value of $60x ($600x value / 10 shares), a holding period of 10 years, and $24x of earnings and profits ($240x / 10 shares) attributable to such portion for purposes of section 1248. Lastly, each share of FT stock will have a fourth portion (attributable to the second block of FT stock) with a basis of $60x ($600x basis / 10 shares), a value of $40x ($400x value / 10 shares), a holding period of 2 years, and $8x of earnings and profits ($80x / 10 shares) attributable to such portion for purposes of section 1248.

*Example 3*. (i) *Facts*. USP, a domestic corporation, owns all the stock of FS, a foreign corporation with 10 shares of stock outstanding. Each share of FS stock has a value of $10x, a basis of $5x, a holding period of 10 years, and $7x of earnings and profits attributable to such share for purposes of section 1248. FP, a foreign corporation, owns the stock of FT, another foreign corporation. FP and FT do not have any section 1248 shareholders. FT has assets with a value of $100x, a basis of $50x, and no liabilities. The FT stock held by FP has a value of $100x and a basis of $75x. FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the reorganization, FP receives USP stock with a value of $100x in exchange for its FT stock.

(ii) *Basis and holding period determination*—(A) Because USP is a section 1248 shareholder of FS immediately before the transaction, the basis and holding period of the FS stock held by USP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by USP immediately before the exchange (the FS portion) and the basis of FT's net assets (the FT portion) immediately before the exchange. The basis of FT's net assets (and not FT stock) is used to determine the FT portion because FT does not have a section 1248 shareholder immediately before the transaction. As a result, the rules of §1.358–6(c) apply to determine the basis of the FT portion of each share of FS stock. The basis and holding period of the FS portion is the basis and holding period of the FS stock held by USP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x, a value of $10x, and a holding period of 10 years. The basis of the FT portion is the basis of the FT assets to which such portion relates. Thus, each share of FS stock has a second portion with a basis of $5x ($50x basis in FT's assets / 10 shares) and a value of $10x ($100x value of FT's assets / 10 shares). All of FS's earnings and profits prior to the transaction ($70x) is attributed solely to the FS portion in each share of FS

stock. The FS portion of each share of FS stock has earnings and profits of $7x ($70x / 10 shares) attributable to such portion for purposes of section 1248. As a result of each share of stock being divided into portions, the basis of the FS stock is not averaged with the basis of the FT assets to increase the section 1248 amount with respect to the stock of the surviving corporation (FS).

*Example 4*. (i) *Facts*. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes a single block of stock with a value of $1,000x, a basis of $600x, and holding period of 5 years. USP, a domestic corporation, forms FS, a foreign corporation, pursuant to the plan of reorganization and capitalizes it with $10x of cash. FS merges into FT with FT surviving in a reverse triangular merger and a reorganization described in section 368(a)(1)(B). Pursuant to the reorganization, US receives USP stock with a value of $1,000x in exchange for its FT stock, and USP receives 10 shares of FT stock with a value of $1,010x in exchange for its FS stock.

(ii) *Basis and holding period determination*. (A) US and USP are section 1248 shareholders of FT and FS, respectively, immediately before the transaction. Neither US nor USP is required to include income under §1.367(b)–3(b) or 1.367(b)–4(b) as described in paragraph (c)(2) of this section. The basis and holding period of the FT stock held by USP is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, each share of the surviving corporation (FT) has a proportionate amount of the basis and holding period of the FT stock immediately before the exchange to which such share relates. Thus, the portion of each share of FT stock attributable to the FT stock has a basis of $60x ($600x basis / 10 shares), a value of $100x ($1,000x value / 10 shares), and a holding period of 5 years. Because the value of FS stock immediately before the triangular reorganization ($10x) is less than one percent of the value of the surviving corporation (FT) immediately after the triangular reorganization ($1,010x), USP may determine its basis in the stock of the surviving corporation (FT) by increasing the basis of each share of FT stock by the proportionate amount of USP's aggregate basis in the FS stock immediately before the exchange (without dividing each share of FT stock into separate portions to account for FS and FT). If USP so elects, USP's basis in each share of FT stock is increased by $1x ($10x basis in FS stock / 10 shares). As a result, each share of FT stock has a basis of $61x, a value of $101x, and a holding period of 5 years.

*Example 5*. (i) *Facts*. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes one block of stock with a basis of $170x, a value of $200x, a holding period of 5 years, and $10x of earnings and profits attributable to such stock for purposes of section 1248. FP, a foreign corporation, owns all the stock of FS, a foreign corporation. FS has 10 shares of stock outstanding. No United States person is a section 1248 shareholder with respect to FP or FS. The FS stock held by FP has a value of $100x and a basis of $50x ($5x per share). FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the merger, US receives FP stock with a value of $200x for its FT stock in an exchange that qualifies for non-recognition under section 354. FP is a controlled foreign corporation and US is a section 1248 shareholder with respect to FP and FS immediately after the exchange.

(ii) *Basis and holding period determination*. (A) Because US is a section 1248 shareholder of FT immediately before the transaction, and US is not required to include income under §§1.367(b)–3(b) and 1.367(b)–4(b) as described in paragraph (c)(2) of this section, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by US immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x and a value of $10x. Because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, the basis and holding period of the FT portion is the proportionate amount of the basis and the holding period of the FT stock immediately before the exchange to which such portion relates. Thus, each share of FS stock will have a second portion with a basis of $17x ($170x basis / 10 shares), a value of $20x ($200x value / 10 shares), a holding period of 5 years, and $1x of earnings and profits ($10x earnings and profits / 10 shares) attributable to such portion for purposes of section 1248.

(iii) *Subsequent disposition*. (A) Several years after the merger, FP disposes of all of its FS stock in a transaction governed by section 964(e). At the time of the disposition, FS stock has decreased in value to $210x (a post-merger reduction in value of $90x), and FS has incurred a post-merger deficit in earnings and profits of $30x.

(B) Pursuant to paragraph (d)(1)(ii) of this section, for purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion, any amount realized on such sale or exchange is allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created. Immediately before the merger, the value of the FS stock in relation to the value of both the FS stock and the FT stock was one-third ($100x / ($100x plus $200x)). Likewise, immediately before the merger, the value of the FT stock in relation to the value of both the FT stock and the FS stock was two-thirds ($200x / $100x plus $200x). Accordingly, one-third of the $210x amount realized is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the amount realized allocated to the FS portion of each share is $7x (one-third of $210x divided by 10 shares). The amount realized allocated to the FT portion of each share is $14x (two-thirds of $210x divided by 10 shares).

(C) Pursuant to paragraph (d)(3) of this section, any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to the divided portions of shares of stock based on the relative fair market value of each divided portion of stock. Accordingly, one-third of the post-merger earnings and profits deficit of $30x is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the deficit in earnings and profits allocated to the FS portion of each share is $1x (one-third of $30x divided by 10 shares). The deficit in earnings and profits allocated to the FT portion of each share is $2x (two-thirds of $30x divided by 10 shares).

(D) When FP disposes of its FS stock, FP is treated as disposing of each divided portion of a share of stock. With respect to the FS portion of each share of stock, FP recognizes a gain of $2x ($7x value - $5x basis), which is not recharacterized as a dividend because a deficit in earnings and profits of $1x is attributable to such portion for purposes of section 1248. With respect to the FT portion of each share of stock, FP recognizes a loss of $3x ($14x value - $17x basis).

(e) *Effective date*. This section applies to exchanges occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 11. Section 1.884–2 is amended as follows:

1. Paragraphs (c)(3) through (c)(6)(i)(A) are revised.

2. Paragraphs (c)(6)(i)(B), (C), and (D) are added.

3. Paragraphs (c)(6)(ii) through (f) are revised.

4. Paragraph (g) is amended by adding a sentence at the end.

The revisions and additions read as follows:

*§1.884–2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.*

* * * * *

(c)(3) through (c)(6)(i)(A) [Reserved]. For further guidance, see §1.884–2T(c)(3) through (c)(6)(i)(A).

(c)(6)(i)(B) Shareholders of the transferee (or of the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E)) who in the aggregate owned more than 25 percent of the value of the stock of the transferor at any time within the 12-month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years

from the close of the taxable year in which the section 381(a) transaction occurs.

(c)(6)(i)(C) In the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E), the transferee's parent sells, exchanges, or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(c)(6)(i)(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in paragraph (c)(6)(i)(A) or (B) of this section) or the transferee's parent (subsequent to an event described in paragraph (c)(6)(i)(C) of this section), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs in the case of a disposition of the stock or securities in the transferee (or the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E)). Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under §1.884–1, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i)(A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations there under.

(c)(6)(ii) through (f) [Reserved]. For further guidance, see §1.884–2T(c)(6)(ii) through (f).

(g) * * * Paragraphs (c)(6)(i)(B), (C), and (D), are applicable for tax years beginning after December 31, 1986, except that such paragraphs are applicable to transactions occurring after the date these regulations are published as final regulations in the **Federal Register** in the case of reorganizations described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E).

Par. 12. In §1.884–2T, paragraphs (c)(6)(i)(B), (C), and (D) are revised to read as follows:

*§1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).*

* * * * *

(c) * * *

(6) * * *

(i) * * *

(B), (C), and (D) [Reserved]. For further guidance, see §1.884–2(c)(6)(i)(B), (C), and (D).

Mark E. Matthews,
*Deputy Commissioner for Services and Enforcement.*

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