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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9345]

RIN 1545-BA93

Section 1248 Attribution Principles

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1248 of the Internal Revenue Code (Code) that provide guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions. The final regulations are necessary in order to supplement and clarify existing guidance in the regulations under section 1248. The final regulations affect persons subject to the regulations under section 1248, as well as persons to which regulations under other Code provisions, such as section 367(b), apply to the extent that those regulations incorporate the principles of the section 1248 regulations. In addition, the final regulations provide that with respect to the sale by a foreign partnership of the stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation for purposes of section 1248.

DATES: Effective Date: These regulations are effective on July 30, 2007.

Applicability Dates: For dates of applicability, see §§1.1248-1(g) and 1.1248-8(d).

FOR FURTHER INFORMATION CONTACT: Michael Gilman at (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

On June 2, 2006, proposed revisions to the regulations under section 1248(a) of the Code (REG-135866-02) were published in the Federal Register (71 FR 31985-01). On August 14, 2006, two corrections to those proposed regulations were published in the Federal Register (71 FR 46415 and 71 FR 46416). Two written comments were received. A public hearing was not requested and none was held. After

consideration of the written comments and other comments, the June 2, 2006, proposed regulations are adopted as amended by this Treasury decision.

Summary of Comments and Explanation of Revisions

With respect to attribution of earnings and profits to stock of an acquiring corporation held by a non-exchanging shareholder, §1.1248-8(b)(4) of the proposed regulations provides a rule by cross-reference to §1.1248-2 or §1.1248-3 (whichever is applicable) and §1.1248-8(b)(6) (as applicable). A commentator asserted that the proposed regulations did not adequately explain which earnings and profits were attributed to the stock of the non-exchanging shareholder. This commentator thought that the rule was better explained in the preamble to the proposed regulations, which states that generally the earnings and profits attributable to stock of an acquiring corporation held by a non-exchanging shareholder immediately prior to a restructuring transaction continue to be attributed to such stock, and the earnings and profits of the acquired corporation accumulated prior to the restructuring transaction attributable to the stock of an acquired corporation are not attributed to the non-exchanging shareholder's stock in the acquiring corporation. In order to clarify the regulations, this language from the preamble to the proposed regulations is included in §1.1248-8(b)(4) of the final regulations.

Under §1.1248-1(a)(4) of the proposed regulations, the partners in a foreign partnership shall be treated as selling or exchanging their proportionate share of stock of a corporation sold or exchanged by the foreign partnership. The proposed regulations also apply section 1248(a) in cases where the stock in a corporation that is sold or exchanged is held through tiers of foreign partnerships. This treatment is necessary to reflect properly each partner's share of the corporation's earnings and profits as a dividend.

A commentator noted that §1.1248-1(a)(4) of the proposed regulations could be read to apply to the sale by a partner of its interest in a partnership holding the stock of a corporation. The Treasury Department and the IRS did not intend that interpretation because it would be contrary to section 1248(g)(2)(B). An amount that is received by a partner in exchange for all or part of its partnership interest is treated as ordinary income under section 751(a) and (c) to the extent attributable to stock in a foreign corporation as described in section 1248. Section 1248(g)(2)(B) provides that section 1248 will not apply if any other provision of the Code treats an amount as ordinary income. Accordingly, §1.1248-1(a)(4) in the final regulations is revised to clarify that a foreign partnership is treated as an aggregate for this purpose only when a foreign partnership sells or exchanges stock of a corporation. Finally, a commentator requested that the final regulations allow a taxpayer to elect to apply the rule in §1.1248-1(a)(4) to taxable years ending before the effective date of the final regulations. The Treasury Department and the IRS regard this rule as a clarification of existing law, but recognize that some practitioners have expressed the view that prior law was not entirely clear. Accordingly, the final regulations allow taxpayers to apply the rule in §1.1248-1(a)(4) to open years provided that the taxpayer consistently applies the rule in all such years. A partner makes this election by treating its distributive share of gain attributable to a sale of shares in a controlled foreign corporation as gain recognized on a

sale or exchange of stock in a foreign corporation within the meaning of section 1248(a).

In order to clarify the application of §1.1248-8, the definition of controlled foreign corporation at §1.1248-8(b)(1)(iii) has been revised to provide that a controlled foreign corporation includes corporations described in either section 953(c)(1)(B) or section 957.

A commentator requested the addition of an example to §1.367(b)-4(d) to clarify that earnings and profits attributable to certain lower-tier subsidiaries are not taken into account in determining the all earnings and profits amount attributable to transactions described in §1.367(b)-3. In response to this comment, such an example is included in §1.367(b)-4(d) of the final regulations.

Special Analyses

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

Drafting Information

The principal author of the final regulations is Michael I. Gilman of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

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

Sections 1.367(b)-2(c)(1) and (2) also issued under 26 U.S.C. 367(b)(1) and (2). Section 1.367(b)-2(d)(3) also issued under 26 U.S.C. 367(b)(1) and (2). * * * Section 1.367(b)-4(d) also issued under 26 U.S.C. 367(b)(1) and (2). * * *

Sections 1.1248-1(a)(1), (4), and (5) also issued under 26 U.S.C. 1248(a) and (c)(1) and (2). * * *

Section 1.1248-8 also issued under 26 U.S.C. 1248(a) and (c)(1) and

(2). * * *

§ 1.367(b)-2 [Amended]

Par. 2. Section 1.367(b)-2 is amended by:

1. Removing the language ", as modified by §1.367(b)-4(d) (as applicable)." from the last sentence of paragraph (c)(1)(ii) and adding the language ". See §1.1248-8." in its place.
2. Removing paragraphs (c)(2) Example 4 and (d)(3)(ii).
3. Removing the language ", as modified by paragraph (d)(3)(ii) of this section and §1.367(b)-4(d) (as applicable)." from the last sentence of paragraph (d)(3)(i)(B)(2) and adding the language ". See §1.1248-8." in its place.
4. Redesignating paragraph (d)(3)(iii) as paragraph (d)(3)(ii).

Par. 3. Section 1.367(b)-4(d) is revised to read as follows:

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

* * * * *

(d) Rules for subsequent sales or exchanges--(1) Rule. If an exchanging shareholder (as defined in §1.1248-8(b)(1)(iv)) is not required to include in income as a deemed dividend the section 1248 amount under paragraph (b) of this section in a section 367(b) exchange described in paragraph (a) of this section (non-inclusion exchange), then, for purposes of applying section 367(b) or section 1248 to subsequent sales or exchanges, and subject to the limitation of §1.367(b)-2(d)(3)(ii) (in the case of a transaction described in §1.367(b)-3), the determination of the earnings and profits attributable to the stock an exchanging shareholder receives in the non-inclusion exchange shall be determined pursuant to the rules of section 1248 and the regulations under that section.

(2) Example. The following example illustrates the rules of this section. For purposes of the example, assume that-

(i) There is no immediate gain recognition pursuant to section 367(a)(1) and the regulations under that section (either through operation of the rules or because the appropriate parties have entered into a gain recognition agreement under §§1.367(a)-3(b) and 1.367(a)-8);

(ii) References to earnings and profits are to earnings and profits that would be includible in income as a dividend under section 1248 and the regulations under that section if stock to which the earnings and profits are attributable were sold or exchanged by its shareholder;

(iii) Each corporation has only a single class of stock outstanding and uses the calendar year as its taxable year; and

(iv) Each transaction is unrelated to all other transactions.

Example. Acquisition of the stock of a foreign corporation that

controls a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a controlled foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a controlled foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of FC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to FC2 in exchange for 80% of the voting stock of FC. CFC1 transfers the voting stock of FC to DC1 and the CFC1 stock is cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), FC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has \$100 of earnings and profits. From January 1, year 4, until December 31, year 5, FC (a controlled foreign corporation after the restructuring transaction) accumulates an additional \$50 of earnings and profits. FC2, a controlled foreign corporation after the restructuring transaction, accumulates \$100 of earnings and profits from January 1, year 4, until December 31, year 5. On December 31, year 5, FC is liquidated into DC1 in a transaction described in section 332.

(ii) Result. Generally, this paragraph (d) requires that DC1 include in income the earnings and profits attributable to its stock in FC as determined under §1.1248-8. However, since the liquidation of FC into DC1 is a transaction described in §1.367(b)-3, the earnings and profits attributable to the stock of FC are limited by §1.367(b)-2(d)(3)(ii) to that portion of the earnings and profits accumulated by FC itself before or after the restructuring transaction, and do not include the earnings and profits of FC's subsidiaries accumulated before or after the restructuring transaction. Thus, DC1 will include \$40 of earnings and profits in income (80% of the \$50 of earnings and profits accumulated by FC after the restructuring transaction).

Par. 4. Section 1.1248-1 is amended by:

1. Removing the language "(or was considered as held by reason of the application of section 1223)" from the first sentence of paragraph (a)(1) and adding the language "(or was considered as held by reason of the application of section 1223, taking into account §1.1248-8)" in its place and adding a new third sentence.

2. Redesignating paragraph (a)(4) as paragraph (a)(5).

3. Adding new paragraphs (a)(4) and (g).

4. Adding Example 4 in newly-designated paragraph (a)(5).

The additions read as follows:

§1.1248-1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) In general. (1) * * * See §1.1248-8 for additional rules regarding the attribution of earnings and profits to the stock of a foreign corporation following certain nonrecognition transactions. * * *

* * * * *

(4) For purposes of paragraph (a)(1) of this section, if a foreign partnership sells or exchanges stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation. Stock which is considered to have been sold or exchanged by a partner by reason of the application of this paragraph (a)(4) shall for purposes of applying such sentence be treated as actually sold or exchanged by such partner.

(5) * * *

Example 4. (i) Facts. X, a domestic corporation, and Y, a foreign corporation that is not a controlled foreign corporation, are partners in foreign partnership Z. X has a 60% interest in Z, and Y has a 40% interest in Z. All parties are calendar year taxpayers. On January 1, year 1, Z forms foreign corporation H, a controlled foreign corporation that conducts a business in Country C. Z and H's functional currency is the United States dollar. In years 1 and 2, H did not earn subpart F income as defined in section 952(a). On December 31, year 2, Z sells all of the H stock for \$600 when Z's adjusted basis in the stock is \$100. Therefore, Z recognizes a gain of \$500 on the sale, of which \$300 is allocable to X as a 60% partner. At the time of the sale, H had \$300 of earnings and profits, \$180 of which (that is, 60% of \$300) is attributable to X's 60% share of the H stock.

(ii) Result. Pursuant to section 1248(a) and paragraphs (a)(1) and (4) of this section, X and Y are treated as selling 60% and 40%, respectively, of the H stock. X includes in its gross income as a dividend \$180 of the gain recognized on the sale. Because Y is a foreign corporation that is not a CFC, neither section 1248 nor section 964 applies to the sale of Y's 40% share of the H stock.

(iii) Alternative facts. If, instead, X owned its 60% interest in Z through another foreign partnership, the result would be the same.

* * * * *

(g) Effective/applicability date. The third sentence in paragraph (a)(1), paragraph (a)(4), and paragraph (a)(5) Example 4 of this section apply to income inclusions that occur on or after July 30, 2007. A taxpayer may elect to apply paragraph (a)(4) of this section to income inclusions in open taxable years provided that it consistently applies paragraph (a)(4) for income inclusions in the first year for which the election is applicable and in all subsequent years.

§§ 1.1248-2, 1.1248-3, 1.1248-7 [Amended]

Par. 5. In §§1.1248-2, 1.1248-3, and 1.1248-7, for each entry in the "Section" column, remove the language in the "Remove" column and add the language in the "Add" column in its place.

Section

Remove

Add

§1.1248-2(a)(1)

(or was considered to be held by reason of the application of section 1223)

(or was considered to be held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-2(a)(2)(ii)

(or is considered to have held by reason of the application of section 1223)

(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-2(a)(3)

(or is considered to have held by reason of the application of section 1223)

(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-2(c)(4)

(or is considered to have held by reason of the application of section 1223)

(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-2(e)(1),

introductory text

(or is considered to have held by reason of the application of section 1223)

(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-2(e)(2)

(or is considered as held by reason of the application of section 1223)

(or is considered as held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-2(e)(3)(i)

(or is considered to have held by reason of the application of section 1223)

(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(a)(1)

(or was considered to be held by reason of the application of section 1223)

(or was considered to be held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(c)(1)(ii)

(or was considered to have held by reason of the application of section 1223)

(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(e)(2)(i)

(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223)

(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(e)(3)

(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223)

(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(e)(5)

(or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223 to the person who sold or exchanged the stock)

(or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223, taking into account §1.1248-8, to the person who sold or exchanged the stock)

§1.1248-3(e)(6), two places

by reason of the application of section 1223 to such person

by reason of the application of section 1223 to such person, taking into account §1.1248-8

§1.1248-3(f)(2)(ii)

(or was considered to have held by reason of the application of section 1223)

(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(f)(5)(ii)

(during the period such stock was considered to be held by such person by reason of the application of section 1223)

(during the period such stock was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-3(f)(5)(iv)

(during the period such share (or block) was considered to be held by such person by reason of the application of section 1223)

(during the period such share (or block) was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-7(b)(3)(i)

(or was considered to have held by reason of the application of section 1223)

(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-7(b)(3)(iii)

(or is considered to have held by reason of the application of section 1223)

(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

§1.1248-7(b)(4) introductory text

(or was considered to have held by reason of the application of section 1223)

(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

Par. 6. Section 1.1248-8 is added to read as follows:

§1.1248-8 Earnings and profits attributable to stock following certain non-recognition transactions.

(a) Scope. This section sets forth rules for the attribution of earnings and profits for purposes of section 1248 and §1.1248-1(a)(1) and to supplement the rules in §§1.1248-2 and 1.1248-3 with respect to--

(1) Stock that an exchanging shareholder receives, or an acquiring corporation receives, in restructuring transactions. Except as otherwise provided in this paragraph (a), stock of a foreign corporation that an exchanging shareholder receives, or an acquiring corporation receives, pursuant to a restructuring transaction (as defined in paragraph (b)(1)(vii) of this section) in which the holding period of such stock is determined by application of section

1223(1) or 1223(2), whichever is appropriate. This section shall not apply to an exchange otherwise described in this paragraph (a)(1) if, as a result of the exchange, the exchanging shareholder is required to include in income as a deemed dividend the section 1248 amount pursuant to §1.367(b)-4(b). See paragraphs (b)(2) and (3) of this section;

(2) Nonexchanging shareholders. Stock of a foreign corporation that participates in a restructuring transaction that is held by a non-exchanging shareholder (as defined in paragraph (b)(1)(vi) of this section) in the restructuring transaction. See paragraph (b)(4) of this section;

(3) Application of section 381. Stock of a foreign corporation that receives assets in a transfer to which section 361(a) applies in connection with a reorganization described in section 368(a)(1)(A), (C), (D), (F), or (G), or in a distribution to which section 332 applies, and to which section 381(c)(2)(A) and §1.381(c)(2)-1(a) apply. See paragraph (b)(6) of this section; or

(4) Section 332 liquidations. Stock of a foreign corporation that receives the assets and liabilities of a foreign corporation in a complete liquidation described in section 332 if the foreign distributee is a foreign corporate shareholder (as defined in paragraph (b)(1)(v) of this section) of the liquidating corporation. See paragraph (c) of this section.

(b) Earnings and profits attributable to stock following a restructuring transaction--(1) Definitions. The following definitions apply for purposes of this

section:

(i) Acquired corporation is a corporation whose stock or assets are acquired in exchange for stock in (or stock in and other property of) either the acquiring corporation or a foreign corporation that controls, within the meaning of section 368(c), the acquiring corporation in a restructuring transaction.

(ii) Acquiring corporation is a corporation that acquires the stock or assets of an acquired corporation in a restructuring transaction.

(iii) Controlled foreign corporation is a corporation described in either section 953(c)(1)(B) or section 957.

(iv) Exchanging shareholder is a person that exchanges--

(A) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 354, 356, or 361(a), stock in an acquired corporation for stock in either a foreign acquiring corporation or a foreign corporation that is in control, within the meaning of section 368(c), of an acquiring corporation (whether domestic or foreign); or

(B) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 351, property (including stock) for stock in a foreign acquiring corporation.

(v) Foreign corporate shareholder is a foreign corporation that--

(A) Owns stock of another foreign corporation; and

(B) Has a section 1248 shareholder that is also a section 1248 shareholder of the other foreign corporation.

(vi) Non-exchanging shareholder is, at the time the acquiring corporation participates in a restructuring transaction, either a section 1248 shareholder or a foreign corporate shareholder of the acquiring corporation that is not an exchanging shareholder with respect to that corporation.

(vii) Restructuring transaction is a transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 351, 354, 356, or 361.

(viii) Section 1248 shareholder is any United States person that satisfies the ownership requirements of section 1248(a)(2) and §1.1248-1(a)(2) with respect to a foreign corporation.

(2) Earnings and profits attributable to stock that an exchanging shareholder receives in a restructuring transaction. Where, in a restructuring transaction, an exchanging shareholder receives stock in a foreign corporation, the holding period of which is determined under section 1223(1), and the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately after the restructuring transaction, the earnings and profits attributable to the stock the exchanging shareholder receives shall be determined pursuant to the rules in paragraphs (b)(2)(i), (ii), and (iii) of this section.

(i) Exchanging shareholder exchanges property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder. Where the exchanging shareholder exchanges in a restructuring transaction property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder immediately before such transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall be determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7) Example 1 of this section.

(ii) Exchanging shareholder exchanges stock of a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. Except as provided in paragraph (b)(2)(iii) of this section, where the exchanging shareholder exchanges in a restructuring transaction stock of a foreign acquired corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder immediately before such restructuring transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall be the sum of the earnings and profits attributable to--

(A) The stock of the foreign acquired corporation exchanged

(determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, and this section, if applicable) that was accumulated before the restructuring transaction; and

(B) The stock of the foreign corporation that the exchanging shareholder receives in the restructuring transaction (determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, and this section, if applicable), without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7) Example 2, Example 4, and Example 6 of this section.

(iii) Exchanging shareholder receives stock in a foreign corporation that controls a domestic acquiring corporation. Where the acquiring corporation is a domestic corporation and the exchanging shareholder receives in a restructuring transaction stock in a foreign corporation that controls (within the meaning of section 368(c)) the domestic acquiring corporation, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall consist solely of the amount of earnings and profits attributable to such stock (determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, and this section, if applicable) without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7) Example 5 of this section.

(3) Earnings and profits attributable to stock in a foreign corporation certain acquiring corporations receive in a restructuring transaction. Where an acquiring corporation receives, in a restructuring transaction, stock in a foreign acquired corporation, the holding period of which is determined under section 1223(2), and the acquiring corporation is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign acquired corporation immediately after the restructuring transaction, the earnings and profits attributable to the foreign acquired corporation stock that the acquiring corporation receives shall be determined pursuant to the rules in paragraphs (b)(3)(i) and (ii) of this section.

(i) Stock of a foreign corporation with respect to which the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder. The earnings and profits attributable to the stock of the foreign acquired corporation that the acquiring corporation receives in a restructuring transaction where the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder with respect to that foreign acquired corporation immediately before the

restructuring transaction shall be determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, without regard to any portion of the section 1223(2) holding period in that stock that is prior to the restructuring transaction.

(ii) Stock of a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. The earnings and profits attributable to the stock of a foreign acquired corporation that the acquiring corporation receives in the restructuring transaction where the exchanging shareholder is either a section 1248 shareholder or a

foreign corporate shareholder with respect to that foreign corporation immediately before the restructuring transaction shall be determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, with regard to the portion of the section 1223(2) holding period of the stock that the exchanging shareholder took into account for purposes of attributing earnings and profits to that stock (determined in accordance with this section). See paragraph (b)(7) Example 3, Example 5, and Example 7 of this section.

(4) Earnings and profits attributable to stock held by a non-exchanging shareholder in a foreign acquiring corporation. (i) Except to the extent paragraph (b)(4)(ii) of this section applies, the earnings and profits attributable to stock of a foreign acquiring corporation held by a non-exchanging shareholder immediately prior to a restructuring transaction continue to be attributed to such stock, and the earnings and profits of the acquired corporation accumulated prior to the restructuring transaction attributable to the stock of an acquired corporation are not attributed to the non-

exchanging shareholder's stock in the foreign acquiring corporation. See §1.1248-2 or §1.1248-3 (whichever is applicable) and, as applicable, paragraph (b)(6) of this section; see also paragraph (b)(7) Example 2 and Example 4 of this section.

(ii) Where a non-exchanging shareholder holds stock in a foreign corporation that is also an exchanging shareholder and a foreign acquiring corporation in the same restructuring transaction--

(A) The earnings and profits attributable to such stock shall be the sum of the

earnings and profits attributable to the stock of such foreign corporation immediately before the restructuring transaction (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of the foreign acquiring

corporation accumulated after the restructuring transaction (including amounts attributed under section 1248(c)(2)); and

(B) Paragraph (b)(6) of this section applies. See paragraph (b)(7) Example 8 of this section.

(iii) Where the acquiring corporation is a foreign corporate shareholder with respect to stock of a foreign acquired corporation, paragraph (b)(3) of this section shall not apply for purposes of determining the earnings and profits attributable to stock in the foreign acquiring corporation owned by a non-exchanging shareholder thereof (see section 1248(c)(2)). See paragraph (b)(7) Example 6 of this section.

(5) Reduction in earnings and profits attributable to stock to prevent multiple inclusions with respect to the same earnings and profits. To the extent consistent with the principles of section 1248, adjustments to earnings and profits attributable to stock shall be made such that section 1223(1) and (2) and this section are applied in a manner that results in earnings and profits being taken into account only once. Thus, for example, when a controlled foreign corporation sells or exchanges all or part of the stock of another foreign corporation to which earnings and profits are attributable

pursuant to this paragraph (b) or paragraph (c) of this section, proportionate reductions shall be made to the earnings and profits attributed to the stock of the selling foreign corporate shareholder owned by a section 1248 shareholder. See paragraph (b)(7) Example 7 of this section.

(6) Special rule regarding section 381. Solely for purposes of determining the earnings and profits (or deficit in earnings and profits) attributable to stock pursuant to this paragraph (b), the earnings and profits of a corporation shall not include earnings and profits that are treated as received or incurred under section 381(c)(2)(A) and §1.381(c)(2)-1(a). See paragraph (b)(7) Example 4 of this section.

(7) Examples. The application of this paragraph (b) is illustrated by the following examples. Unless otherwise indicated, in the following examples assume that--

(i) There is no immediate gain recognition pursuant to section 367(a)(1) and the regulations under that section (either through operation of the rules or because the appropriate parties have entered into a gain recognition agreement under §§1.367(a)-3(b) and 1.367(a)-8);

(ii) There is no income inclusion required pursuant to section 367(b) and the regulations under that section, and all reporting requirements in those regulations are complied with;

(iii) References to earnings and profits are to earnings and profits that would be includible in income as a dividend under section 1248 and the regulations under that section if stock to which the earnings and profits are attributable were sold or exchanged by its shareholder;

(iv) Each corporation has only a single class of stock outstanding and uses the calendar year as its taxable year; and

(v) Each transaction is unrelated to all other transactions.

Example 1. A section 351 exchange of property other than stock in a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC, a foreign corporation, since CFC's formation on January 1, year 3. On December 31, year 5, DC2, a domestic corporation unrelated to DC1, contributes property it has held since January 1, year 1, to CFC in exchange for voting stock of CFC in a restructuring transaction that is an exchange under section 351. The property that DC2 contributes is not stock in a foreign corporation with respect to which DC2 was either a section 1248 shareholder or a foreign corporate shareholder. DC2 receives 80% of the voting stock of CFC in the restructuring transaction and its holding period in that CFC stock, determined pursuant to section 1223(1), began on January 1, year 1. CFC has \$100 of accumulated earnings and profits on December 31, year 5. On December 31, year 7, when the accumulated earnings and profits of CFC are \$200, DC2, a section 1248 shareholder with respect to CFC, sells its CFC stock.

(ii) Result. Under paragraph (b)(2)(i) of this section, the earnings and profits attributable to the CFC stock sold by DC2 are \$80. This

amount consists of none of the \$100 of earnings and profits accumulated by CFC before the restructuring transaction, and 80% of the \$100 of earnings and profits of CFC accumulated after the restructuring transaction.

Example 2. A section 351 exchange of controlled foreign corporation stock by a United States person for stock in a controlled foreign corporation in a restructuring transaction. (i) Facts. The facts are the same as in Example 1 except as follows. The property that DC2 contributes is 100% of the stock in CFC2, a foreign corporation. DC2 has owned all the stock of CFC2 since CFC2's formation on January 1, year 2, and CFC2 has \$200 of earnings and profits as of December 31, year 5. CFC2 does not accumulate any additional earnings and profits from December 31, year 5, to December

31, year 7. On December 31, year 7, when the accumulated earnings and profits of CFC are \$200, DC2, a section 1248 shareholder with respect to CFC, sells its CFC stock. Also on that date, DC1 sells its CFC stock.

(ii) Result. (A) DC2 sale. Pursuant to paragraph (b)(2)(ii) of this section, the earnings and profits attributable to the CFC stock sold by DC2 are \$280. This amount consists of all of the \$200 of earnings and profits of CFC2 accumulated before the restructuring transaction (see also section 1248(c)(2)), none of the \$100 of earnings and profits accumulated by CFC before the restructuring transaction, and 80% of the \$100 of earnings and profits of CFC accumulated after the restructuring transaction.

(B) DC1 sale. Pursuant to paragraph (b)(4) of this section, the earnings and profits attributable to the CFC stock sold by DC1, a non-exchanging shareholder in the restructuring transaction, are \$120. This amount consists of all of the \$100 of earnings and profits of CFC accumulated before the restructuring transaction, none of the \$200 of earnings and profits of CFC2 accumulated before the restructuring transaction, and 20% of the \$100 of earnings and profits of CFC accumulated after the restructuring transaction.

Example 3. A section 351 exchange of controlled foreign corporation stock by a United States person for stock in a domestic corporation in a restructuring transaction. (i) Facts. DC1, a domestic corporation, has owned all of the stock of CFC, a foreign corporation, since CFC's formation on January 1, year 1. DC1 has also owned all the stock of DC2, a domestic corporation, since DC2's formation on January 1, year 1. On December 31, year 2, DC1 contributes the stock of CFC to DC2 in exchange for stock in DC2 in a restructuring transaction that is an exchange described in section 351. On December 31, year 2, CFC has \$100 of accumulated earnings and profits. DC2 has a basis in the CFC stock determined under section 362, and is considered to have held the CFC stock since January 1, year 1, pursuant to section 1223(2). On December 31, year 4, when the accumulated earnings and profits of CFC are still \$100, DC2 sells its CFC stock.

(ii) Result. Under paragraph (b)(3)(ii) of this section, \$100 of accumulated earnings and profits of CFC is attributable to the stock of CFC sold by DC2, even though DC2 did not hold the stock of CFC during the time CFC accumulated the earnings and profits.

Example 4. Acquisition of a controlled foreign corporation by a

controlled foreign corporation in a reorganization described in section 368(a)(1)(C) (or section 368(a)(1)(B)). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation unrelated to DC1, has owned all of the stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets to CFC2 in exchange for 25% of the voting stock of CFC2. CFC1 distributes the CFC2 stock to DC1 and the CFC1 stock is cancelled. DC1's holding period in the CFC2 stock, determined under section 1223(1), begins on January 1, year 1. On December 31, year 3, CFC1 has \$100 of accumulated earnings and profits and CFC2 has \$200 of accumulated earnings and profits. CFC2 succeeds to the \$100 of CFC1 accumulated earnings and profits in the reorganization under section 381. From January 1, year 4 to December 31, year 5, CFC2 incurred a deficit in earnings and profits in the amount of (\$200). On December 31, year 5, both DC1 and DC2 sell their stock in CFC2.

(ii) Result. (A) DC1. Pursuant to paragraph (b)(2)(ii) of this section, \$50 of earnings and profits is attributable to the CFC2 stock sold by DC1. This amount consists of \$100 of CFC1's earnings and profits accumulated before the restructuring transaction, reduced by 25% of CFC2's (\$200) post-restructuring transaction deficit in earnings and profits. None of the \$200 of CFC2's earnings and profits accumulated by CFC2 prior to the reorganization is attributed to the CFC2 stock sold by DC1. Also, none of the earnings and profits CFC2 succeeded to under section 381 is attributed to the CFC2 stock sold by DC1, pursuant to paragraph (b)(6) of this section.

(B) DC2. Pursuant to paragraph (b)(4) of this section, there is \$50 of accumulated earnings and profits attributable to the CFC2 stock sold by DC2. This amount consists of all of the \$200 of CFC2's earnings and profits accumulated by CFC2 prior to the reorganization, reduced by 75% of CFC2's deficit in earnings and profits in the amount of (\$200) incurred after the restructuring transaction. None of the \$100 of CFC1 accumulated earnings and profits succeeded to under section 381 is attributable to the CFC2 stock sold by DC2, pursuant to paragraph (b)(6) of this section.

(C) Section 368(a)(1)(B) reorganization. If, instead of DC1 acquiring its 25% interest in CFC2 pursuant to a reorganization described in section 368(a)(1)(C), DC1 had transferred the stock of CFC1 to CFC2 in exchange for 25% of the voting stock of CFC2 in a reorganization described in section 368(a)(1)(B), the results would be the same as described in paragraphs (ii) (A) and (B) of this Example 4.

Example 5. Acquisition of the stock of a foreign corporation that controls a domestic acquiring corporation in a triangular reorganization described in section 368(a)(1)(C). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of DC2, a domestic corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to DC2 in

exchange for 60% of the voting stock of FC. CFC1 transfers the voting stock of FC to DC1 and the CFC1 stock is cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), DC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has \$100 of earnings and profits, CFC2 has \$300 of earnings and profits, and FC has \$200 of earnings and profits. DC1 includes the \$100 all earnings and profits amount attributable to its CFC1 stock in income as a deemed dividend under §1.367(b)-3 upon the exchange of CFC1 stock for FC stock. Pursuant to the lower-tier earnings exclusion of §1.367(b)-2(d)(3)(ii), that amount does not include the \$300 of earnings and profits of CFC2. From January 1, year 4, until December 31, year 5, FC (now a controlled foreign corporation)

accumulates an additional \$50 of earnings and profits. From January 1, year 4 until December 31, year 5, CFC2 accumulates an additional \$100 of earnings and profits. On December 31, year 5, DC1 sells its stock in FC and DC2 sells its stock in CFC2.

(ii) Result. (A) DC1. Pursuant to paragraph (b)(2)(iii) of this section, there is \$30 of earnings and profits attributable to the stock of FC sold by DC1. This amount consists of 60% of the \$50 of earnings and profits accumulated by FC after the restructuring transaction, and none of the earnings and profits accumulated by CFC1, CFC2, or FC before the restructuring transaction.

(B) DC2. Pursuant to paragraph (b)(3)(ii) of this section, there is \$400 of earnings and profits attributable to the stock of CFC2 sold by DC2. This amount

consists of all of the earnings and profits accumulated by CFC2 during DC2's section 1223(2) holding period.

Example 6. Acquisition of the stock of a foreign corporation that controls a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of FC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to FC2 in exchange for 60% of the voting stock of FC. CFC1 transfers the voting stock of FC to DC1 and the CFC1 stock is cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), FC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has \$100 of earnings and profits, CFC2 has \$300 of earnings and profits, FC has \$200 of earnings and profits, and FC2 has no earnings and profits. From January 1, year 4, until December 31, year 5, FC (now a controlled foreign corporation) accumulates an additional \$50 of earnings and profits. From January 1, year 4 until December 31, year 5, CFC2 accumulates an additional \$100 of earnings and profits. FC2, a controlled foreign corporation after the restructuring transaction, accumulates \$100 of earnings and profits from January 1, year 4, until December 31, year 5. On December 31,

year 5, DC1 sells its stock in FC.

(ii) Result. Pursuant to paragraphs (b)(2)(ii) and (b)(4)(iii) of this section, there is \$550 of earnings and profits attributable to the stock of FC sold by DC1. This amount consists of all \$400 of the CFC1 and CFC2 earnings and profits accumulated before the restructuring transaction (see also section 1248(c)(2)), and 60% of the \$250 of the earnings and profits accumulated by FC, FC2, and CFC2 after the restructuring transaction.

Example 7. Acquisition of controlled foreign corporation stock by a controlled foreign corporation in a reorganization described in section 368(a)(1)(B), followed by a sale of the acquired stock by the acquiring controlled foreign corporation. (i) Facts. DC1, a domestic corporation, has owned all of the outstanding stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all of the outstanding stock of CFC3, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation unrelated to DC1, has owned all of the outstanding stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(B), CFC1 transfers all of the stock of CFC3 to CFC2 in exchange for 40% of CFC2's stock. On December 31, year 3, CFC2 and CFC3 have, respectively, \$40 and \$20 of earnings and profits. On December 31, year 5, when the accumulated earnings and profits of CFC3 are \$50 (\$20 of earnings and profits as of December 31, year 3, plus \$30 of earnings and profits generated from January 1, year 4, through December 31, year 5), CFC2 sells the stock of CFC3 in a transaction to which section 964(e) applies.

(ii) Result. (A) CFC2. Pursuant to paragraph (b)(3)(ii) of this section, there is \$50 of earnings and profits attributable to the CFC3 stock sold by CFC2. This amount consists of the accumulated earnings and profits attributable to CFC2's entire section 1223(2) holding period in the CFC3 stock.

(B) CFC1, DC2, and DC1. Under paragraph (b)(5) of this section, the earnings and profits attributable to the CFC2 stock held by CFC1 and DC2, and the earnings and profits attributable to the CFC1 stock held by DC1, will be reduced (regardless of whether CFC2 recognizes gain on its sale of CFC3 stock).

(1) CFC1. The earnings and profits attributable to the CFC2 stock held by CFC1 will be reduced by \$32, or the amount of earnings and profits as of December 31, year 5, that would have been attributable to the CFC2 stock held by CFC1 pursuant to paragraph (b)(2)(ii) of this section. This amount consists of all of the \$20 of earnings

and profits accumulated by CFC3 before the restructuring transaction and 40% of the \$30 of earnings and profits accumulated by CFC3 after the restructuring transaction ($.40 \times \$30 = \12).

(2) DC1. The earnings and profits attributable to the CFC1 stock held by DC1 will also be reduced by \$32, or the amount of earnings and profits that would have been attributable to the CFC1 stock held by DC1 as of December 31, year 5.

(3) DC2. The earnings and profits attributable to the CFC2 stock held by DC2 will be reduced by \$18, or the amount of earnings and profits

that would have been attributable to the CFC2 stock held by DC2 as of December 31, year 5, under paragraph (b)(4) of this section. This amount consists of 60% of the \$30 (.60 X \$30 = \$18) of earnings and profits accumulated by CFC3 after the restructuring transaction.

(C) Partial sale by CFC2. If, instead of selling 100% of the CFC3 stock, on December 31, year 5, CFC2 sells only 50% of its CFC3 stock, paragraph (b)(5) of this section requires CFC1 to reduce the earnings and profits of CFC3 attributable to its CFC2 stock to \$16. Similarly, DC1 would be required to reduce the earnings and profits of CFC3 attributable to its CFC1 stock by \$16. Paragraph (b)(5) of this section also requires DC2 to reduce the CFC3 earnings and profits attributable to its CFC2 stock by \$9. These reductions occur without regard to whether CFC2 recognizes gain on its sale of CFC3 stock.

Example 8. Acquisition of the assets of a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation in a restructuring transaction described in section 368(a)(1)(C). (i) Facts. DC, a domestic corporation, has owned all the stock of CFC1, a controlled foreign corporation, since its formation on January 1, year 1. CFC1 is a holding company that has owned 79% of the stock of CFC2, a controlled foreign corporation, since its formation on January 1, year 1. The other 21% of CFC2 stock is owned by X, an unrelated party. On December 31, year 1, CFC2 has \$200 of earnings and profits. On December 31, year 1, CFC1 has no accumulated earnings and profits. On December 31, year 1, pursuant to a restructuring transaction described in section 368(a)(1)(C), CFC2 transfers all its properties to CFC1. In exchange, CFC1 assumes the liabilities of CFC2 and transfers to CFC2 voting stock representing 21% of the stock of CFC1. CFC2 distributes the voting stock to X and liquidates. The liabilities assumed do not exceed 20% of the value of the properties of CFC2. From January 1, year 2, to December 31, year 3, CFC1 accumulates \$100 of earnings and profits. On December 31, year 3, DC sells its CFC1 stock.

(ii) Result. Pursuant to paragraph (b)(4)(ii) of this section, there is \$237 of earnings and profits attributable to DC's CFC1 stock. This amount consists of 79% of CFC2's \$200 of earnings and profits accumulated before the restructuring transaction (see section 1248(c)(2)), and 79% of CFC1's \$100 of earnings and profits accumulated

after the restructuring transaction. Pursuant to paragraph (b)(6) of this section, none of CFC2's \$200 of earnings and profits to which CFC1 succeeded under section 381 would be attributable to DC's CFC1 stock.

(c) Earnings and profits attributable to stock of a foreign distributee corporation that is a foreign corporate shareholder with respect to a foreign liquidating corporation--(1) General rule. If a foreign corporation (liquidating corporation) makes a distribution of property in complete liquidation under section 332 to a foreign corporation (distributee), and immediately before the liquidation the distributee was a foreign corporate shareholder with respect to the liquidating foreign corporation, the amount of

earnings and profits attributable to the distributee stock upon its subsequent sale or exchange will be determined under this paragraph (c)(1). The earnings and profits attributable will be the sum of the earnings and profits attributable to the stock of the distributee

immediately before the liquidation (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of the distributee accumulated after the liquidation (including amounts attributed under section 1248(c)(2)).

(2) Special rule regarding section 381. Solely for purposes of determining the earnings and profits (or deficit in earnings and profits) attributable to stock under this paragraph (c), the attributed earnings and profits of a corporation shall not include earnings and profits that are treated as received or incurred pursuant to section 381(c)(2)(A) and §1.381(c)(2)-1(a).

(3) Example. (i) Facts. DC, a domestic corporation, has owned all of the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 is an operating company that has owned all of the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. On December 31, year 2, CFC1 has \$200 of accumulated earnings and profits and CFC2 has a (\$200) deficit in earnings and profits. On December 31, year 2, CFC2 distributes all of its assets and liabilities to CFC1 in a liquidation to which section 332 applies. From January 1, year 3, until December 31, year 4, CFC1 accumulates no additional earnings and profits. On December 31, year 4, DC sells its stock in CFC1.

(ii) Result. Pursuant to paragraph (c)(1) of this section, there are no earnings and profits attributable to DC's CFC1 stock. This amount consists of the sum of the earnings and profits attributable to the CFC1 stock immediately before the liquidation (100% of the \$200 accumulated earnings and profits of CFC1 and 100% of CFC2's (\$200) deficit in earnings and profits) and the amount of earnings and profits accumulated after the section 332 liquidation (see also section 1248(c)(2)).

(d) Effective/applicability date. This section applies to income inclusions that occur on or after July 30, 2007.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Approved: July 16, 2007.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

18

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