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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9591]

RIN 1545-BF47

Surrogate Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding whether a foreign corporation is treated as a surrogate foreign corporation. The final regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or partnerships.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.7874-1(g) and 1.7874-2(l).

FOR FURTHER INFORMATION CONTACT: Milton M. Cahn, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

On June 6, 2006, temporary regulations under section 7874 of the Internal Revenue Code (Code) (TD 9265, 2006-2 CB 1) were published in the **Federal Register** (71 FR 32437) concerning the treatment of a foreign corporation as a surrogate foreign corporation (2006 temporary regulations). A notice of proposed rulemaking (REG-112994-06) cross-referencing the 2006 temporary regulations was published in the same issue of the **Federal Register** (71 FR 32495). On July 28, 2006, Notice 2006-70 (2006-2 CB 252) was published, announcing a modification to the effective date contained in the 2006 temporary regulations. See §601.601(d)(2)(ii)(b). On June 12, 2009, the 2006 temporary regulations and the related notice of proposed rulemaking were withdrawn and replaced with new temporary regulations (2009 temporary regulations), which generally applied to acquisitions completed on or after June 9, 2009. TD 9453 (74 FR 27920, 2009-2 CB 114). A notice of proposed rulemaking (REG-112994-06) cross-referencing the 2009 temporary regulations was published in the same issue of the **Federal Register** (74 FR 27947, 2009-2 CB 144). No public hearing was requested or held; however, comments were received. All comments are available at [www.regulations.gov](http://www.regulations.gov) or upon request. After consideration of the comments, the 2009 proposed regulations are adopted as final regulations with the modifications described in this preamble. The 2009 temporary regulations are removed. As discussed in paragraph A. of this preamble, new temporary regulations under section 7874 regarding whether a foreign corporation has substantial business activities in a foreign country, and a corresponding notice of proposed rulemaking, are published elsewhere in this issue of the **Federal Register**.

### **Summary of Comments and Explanation of Revisions**

## A. Substantial Business Activities

A foreign corporation is generally treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions): (i) the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation; (ii) after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and (iii) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country (relevant foreign country) in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Similar provisions apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

The 2006 temporary regulations provided that the determination of whether the expanded affiliated group has substantial business activities in the relevant foreign country is based on all the facts and circumstances. The 2006 temporary regulations also provided a safe harbor, which generally was satisfied if at least ten percent of the employees, assets, and sales of the expanded affiliated group were in the relevant foreign country. The 2009 temporary regulations retained the facts and circumstances general rule provided in the 2006 temporary regulations, with certain modifications, but removed the safe harbor.

Comments were received regarding the determination as to whether an expanded affiliated group has substantial business activities in a foreign country. These comments are discussed in the preamble to temporary regulations, published elsewhere in this issue of the **Federal Register**, that provide guidance on the substantial business activities test.

## B. Options

### 1. General approach

The 2009 temporary regulations generally provide that, for purposes of section 7874, an option or similar interest (together, an “option”) with respect to a corporation is treated as stock of the corporation with a value equal to the holder’s claim on the equity of the corporation. For this purpose, the equity of the corporation does not include the value of any property the holder of the option would be required to provide to the corporation pursuant to the terms of the option if such option were exercised. The 2009 temporary regulations provide similar rules for an option with respect to a partnership.

A comment suggested that, subject to an anti-abuse rule, options should be ignored for purposes of section 7874. The comment asserts that this approach, consistent with the treatment of options under other Code sections, would be more administrable; the comment recognized, however, that unlike the approach taken in the 2009 temporary regulations, this approach does not properly take into account the economic interest of an option holder. Alternatively, the comment suggested that if the approach taken in the 2009 temporary regulations is retained, certain types of options (for example, publicly traded options and customary compensatory options) should be excluded from the general rule.

The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) believe that the claim-on-equity approach in the 2009 temporary regulations is preferable to disregarding options subject to an anti-avoidance rule. The IRS and the Treasury Department believe this approach most properly reflects the economics of the transaction and is not easily manipulated. Moreover, the IRS and the Treasury Department believe that the simplicity of uniformly treating all types of options outweighs the benefits of excluding, or providing other special rules for, certain types of options. Accordingly, the claim-on-equity approach provided in the 2009 temporary regulations is retained, with certain modifications, in these final regulations.

## 2. Voting power

Certain portions of section 7874 also look to the voting power of stock. For example, one of the requirements for a foreign corporation to be treated as a surrogate foreign corporation is that, after the acquisition, at least 60 percent of the stock (by vote or value) of the entity is held, in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation. Section 7874(a)(2)(B)(ii). As discussed in section B.1. of this preamble, however, the 2009 temporary regulations only address options with respect to the amount of stock treated as held by value; they do not address the effect of options on voting power.

A comment suggested that if the general approach of the 2009 temporary regulations is retained, the effect options have on voting power, if any, should be addressed. Specifically, the comment suggested that options could be treated as: (i) not having voting power; (ii) having voting power corresponding to the number of shares

the value of which equals the claim on equity; or (iii) having voting power corresponding to the number of shares that would be obtained upon exercise of the option.

In response to this comment, the final regulations provide that for purposes of determining the voting power of stock under section 7874, an option will be treated as exercised if a principal purpose of the issuance or acquisition of the option is to avoid treating the foreign corporation as a surrogate foreign corporation. In all other cases, options are not taken into account for purposes of determining the voting power of stock under section 7874.

### 3. Effect of options on equity holders

A comment requested clarification that if an option is treated as stock under the claim-on-equity approach, then the ownership percentages of shareholders are reduced. The IRS and the Treasury Department believe that the value of stock inherently reflects the existence of options that have a claim on equity. Therefore, no adjustment to the value of stock under the regulations is necessary. For example, if the stock of a foreign corporation has an aggregate value of \$100x (which reflects the existence of options) and there is a single option outstanding with a claim on equity of \$10x with respect to the foreign corporation, then under the regulations the total value of the stock of the foreign corporation is treated as \$110x for purposes of section 7874. An example in the regulations is modified to clarify this result.

### 4. Other rules

The 2009 temporary regulations provide that, with respect to a foreign corporation, the general option rule does not apply if a principal purpose of the issuance or acquisition of the option is to avoid the foreign corporation being treated as a

surrogate foreign corporation. The 2009 temporary regulations do not contain a similar rule with respect to domestic corporations or domestic partnerships.

A comment questioned why the anti-abuse rule only applies to foreign corporations and noted that avoidance concerns may equally be present with options in domestic corporations or partnerships. Accordingly, the comment suggested that the anti-abuse rule be extended to apply to options with respect to domestic corporations and domestic partnerships. The IRS and the Treasury Department agree with this comment. As a result, the final regulations modify the anti-abuse rule such that it applies to options with respect to all corporations and partnerships, domestic or foreign.

Another comment suggested that the regulations include special rules to take into account certain types of options, such as options subject to vesting and nontransferable options. In response to this comment, the final regulations provide that the claim-on-equity approach does not apply if, at the time of the acquisition, the probability that the option will be exercised is remote.

The final regulations clarify that the rules addressing options also apply for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1). In addition, the text of the final regulations is clarified to provide that a claim on equity equals the value of the stock or partnership interest that may be acquired pursuant to the option, less the exercise price (but in no case is a claim on equity less than zero).

### C. Insolvent Entities

The 2009 temporary regulations provide that, for purposes of section 7874, if immediately prior to the first date properties are acquired as part of an acquisition

described in section 7874(a)(2)(B)(i), a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then any claim by a creditor against the domestic corporation shall be treated as stock of the domestic corporation. A similar rule applies with respect to a domestic partnership, or a foreign partnership that owns stock of a domestic corporation.

A comment was received stating that, in certain cases, the creditors should be viewed as purchasers of the insolvent entity's assets and, as a result, the transaction should not be subject to section 7874. The comment further stated that applying section 7874 to such creditors could provide third-party bidders for the entity's assets an undue advantage over existing creditors because such bidders would not be subject to section 7874. Accordingly, the comment suggested that the insolvency rule be modified to only apply where creditors acquire the insolvent entity's debt pursuant to a plan to acquire its stock or assets.

The IRS and the Treasury Department believe that, for purposes of section 7874, the creditors of an insolvent entity should be considered the equity holders of the entity. Furthermore, the IRS and the Treasury Department do not believe that insolvent entities should be treated more favorably than other entities under section 7874. Accordingly, this comment is not adopted.

#### D. Acquisitions of Multiple Domestic Entities and Disregard of Affiliate-Owned Stock

The 2009 temporary regulations generally provide that if, pursuant to a plan (or series of related transactions), a foreign corporation completes two or more acquisitions described in section 7874(a)(2)(B)(i) involving domestic corporations or partnerships



(domestic entities) then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions are treated as a single acquisition and the domestic entities are treated as a single domestic entity.

Section 7874(c)(2)(A) and §1.7874-1 provide special rules for determining ownership under section 7874(a)(2)(B)(ii) for stock held by members of the expanded affiliated group that includes the foreign corporation. Section 7874(c)(2)(B) provides that stock of the foreign corporation that is sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i) is not taken into account for purposes of determining ownership under section 7874(a)(2)(B)(ii).

A comment requested clarification as to the application of section 7874(c)(2)(A) and §1.7874-1 when acquisitions of two or more domestic entities are treated as a single domestic entity under the 2009 temporary regulations. The IRS and the Treasury Department are studying the manner in which §1.7874-1 should interact with various rules under section 7874, including the rules in section 7874(c)(2)(B), §1.7874-2(e), and Notice 2009-78 (2009-2 CB 452) (determination of the ownership fraction when stock is issued in exchange for certain types of property). See §601.601(d)(2)(ii)(b). Accordingly, no change has been made to this regulation, but the IRS and the Treasury Department request comments regarding the interaction of §1.7874-1 and other rules under section 7874 related to the ownership fraction.

#### E. Downstream Transactions

The final regulations clarify that an acquisition by a corporation of its stock from another corporation or a partnership is an acquisition of the transferor's properties for purposes of section 7874(a)(2)(B)(i). This rule applies even though, for Federal tax

purposes, the acquired stock no longer exists after the transaction. Thus, for example, if a domestic corporation that holds stock in a foreign corporation merges into the foreign corporation, the foreign corporation is, for purposes of section 7874(a)(2)(B)(i), treated as acquiring properties of the domestic corporation in the form of the foreign corporation's stock.

### **Effective/Applicability Dates**

These final regulations apply to acquisitions completed on or after **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to this regulation and because the regulation does not impose a collection of information on small entities, the requirements of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) do not apply. Pursuant to section 7805(f) of the Internal Revenue 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 its impact on small business.

### **Drafting Information**

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

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

## 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 continues to read in part as follows:

Authority: 26 USC 7805 \* \* \*

Sections 1.7874-1 and 1.7874-2 also issued under 26 U.S.C. 7874(c)(6) and (g).

\* \* \*

Par. 2 Section 1.7874-1 is amended by:

1. Revising paragraph (e).
2. Adding two sentences at the end of paragraph (g).

The revision and addition read as follows:

§1.7874-1 Disregard of affiliate-owned stock.

\* \* \* \* \*

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

\* \* \* \* \*

(g) \* \* \* Paragraph (e) of this section shall apply to acquisitions completed on or after **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY**

**THE FEDERAL REGISTER]**. See §1.7874-1T(e), as contained in 26 CFR part 1

revised as of April 1, 2012, for acquisitions completed before **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**.

**§1.7874-1T [Removed]**

Par. 3. Section 1.7874-1T is removed.

Par. 4. Section 1.7874-2 is added to read as follows:

**§1.7874-2 Surrogate foreign corporation.**

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

concerning the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b). Paragraph (k) of this section provides examples that illustrate the rules of this section. Paragraph (l) of this section provides the effective/applicability date of this section.

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

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

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

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

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

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

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

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

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

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

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

(9) The determination of whether a foreign corporation is a surrogate foreign corporation is made after the acquisition described in section 7874(a)(2)(B)(i). A foreign corporation that is treated as a surrogate foreign corporation (including a surrogate foreign corporation treated as a domestic corporation described in section 7874(b)) shall continue to be treated as a surrogate foreign corporation (or a domestic corporation), even if the conditions of section 7874(a)(2)(B)(ii) and (iii) are not satisfied at a later date.

(c) Acquisition of properties--(1) Indirect acquisition of properties. For purposes of section 7874(a)(2)(B)(i), an indirect acquisition of properties held by a domestic corporation (or a partnership) includes, but is not limited to, the acquisitions described in paragraphs (c)(1)(i) through (iv) of this section. An acquisition of less than all of the stock of a domestic corporation (or interests in a partnership) shall constitute an indirect acquisition of a proportionate amount of the properties held by the domestic corporation or the partnership. See paragraph (b)(8) of this section for rules determining the proportionate amount of properties indirectly acquired.

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

(ii) An acquisition of an interest in a partnership. See Example 2 of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(1)(ii).

(iii) An acquisition by a corporation (acquiring corporation) of properties held by a domestic corporation (or a partnership) in exchange for stock of a foreign corporation (foreign issuing corporation) that is part of the expanded affiliated group that includes the acquiring corporation after the acquisition shall be treated as an acquisition by the foreign issuing corporation. See Example 3 of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(1)(iii).

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

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

(3) Downstream transactions. An acquisition by a corporation of its stock from another corporation or a partnership (for example, as a result of a downstream merger)

is an acquisition of the other corporation's or partnership's properties for purposes of section 7874(a)(2)(B)(i).

(d) Acquisitions by multiple foreign corporations. If, pursuant to a plan (or a series of related transactions), two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i), then each foreign corporation shall be treated as completing the acquisition for purposes of determining whether such foreign corporation is treated as a surrogate foreign corporation. See Examples 5 and 6 of paragraph (k) of this section for illustrations of the rules of this paragraph (d).

(e) Acquisitions of multiple domestic entities. If, pursuant to a plan (or a series of related transactions), a foreign corporation completes two or more acquisitions described in section 7874(a)(2)(B)(i) involving domestic corporations and/or domestic partnerships (domestic entities), then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions shall be treated as a single acquisition and the domestic entities shall be treated as a single domestic entity. If the transaction involves one or more domestic corporations and one or more domestic partnerships, the stock of the foreign corporation held by former shareholders and former partners by reason of holding stock or a partnership interest in the domestic entities shall be aggregated for purposes of determining whether the ownership condition of section 7874(a)(2)(B)(ii) is satisfied. See Example 7 of paragraph (k) of this section for an illustration of the rules of this paragraph (e).

(f) Stock held by reason of holding stock in a domestic corporation or an interest in a domestic partnership--(1) Specified transactions. For purposes of section



7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) includes, but is not limited to, the stock described in paragraphs (f)(1)(i) through (iii) of this section.

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

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

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

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

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

shall be determined based on the relative value of the interest in the domestic partnership compared to the aggregate value of such interest and the other property.

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

(g) Publicly traded foreign partnerships--(1) Treatment as a foreign corporation.

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

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

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

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

(3) Surrogate foreign corporation to which section 7874(b) applies. If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, the publicly traded foreign partnership shall be treated as a domestic corporation for purposes of the Internal Revenue Code (Code). See paragraph (g)(6) of this section for the timing and treatment of the conversion of the publicly traded foreign partnership to a domestic corporation. See Example 11 of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(3).

(4) Surrogate foreign corporation to which section 7874(b) does not apply. If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) does not apply, the publicly traded foreign partnership shall continue to be treated as a foreign partnership for purposes of the Code, but section 7874(a)(1) shall apply to any expatriated entity (as defined in section 7874(a)(2)(A)). See Example 13 of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(4).

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

(6) Conversion to a domestic corporation. Except for purposes of determining whether the publicly traded foreign partnership is a surrogate foreign corporation, if

paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, then at the later of the end of the day immediately preceding the first date properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i) or immediately after the formation of the publicly traded foreign partnership, the publicly traded foreign partnership shall be treated as transferring all of its assets and liabilities to a newly formed domestic corporation in exchange solely for stock of the domestic corporation, and then distributing such stock to its partners in proportion to their partnership interests in liquidation of the partnership. The treatment of the transfer of assets and liabilities to the domestic corporation and the distribution of the stock of the domestic corporation to the partners in liquidation of the partnership shall be determined under all relevant provisions of the Code and general tax principles.

(h) Options--(1) Value. Except to the extent otherwise provided in this paragraph (h), for purposes of section 7874, including for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1), an option with respect to a corporation or partnership will be treated as stock in the corporation, or an interest in the partnership, as applicable, with a value equal to the holder's claim on the equity of the corporation or partnership. For this purpose, claim on the equity equals the value of the stock or partnership interest that may be acquired pursuant to the option, less the exercise price (but in no case is a claim on the equity less than zero). Also for this purpose, the equity of the corporation or partnership shall not include the amount of any property the holder of the option would be required to provide to the corporation or partnership under the terms of the option if such option were exercised. See Example

14 and Example 16 of paragraph (k) of this section for illustrations of the rules of this paragraph (h)(1).

(2) Voting power. Except to the extent otherwise provided in this paragraph (h), for purposes of determining the voting power of a foreign corporation under section 7874, including for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1), an option will be treated as exercised only if a principal purpose of the issuance or transfer of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation.

(3) Timing. For purposes of this paragraph (h), the value of the holder's claim on the equity is determined--

(i) In the case of a domestic corporation or a domestic partnership, immediately before the acquisition described in section 7874(a)(2)(B)(i).

(ii) In the case of a foreign corporation or foreign partnership, immediately after the acquisition described in section 7874(a)(2)(B)(i).

(4) Certain options disregarded. The rules of paragraph (h)(1) of this section shall not apply to an option if--

(i) A principal purpose of the issuance or acquisition of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation, or

(ii) At the time of the acquisition described in section 7874(a)(2)(B)(i), the probability of the option being exercised is remote.

(5) Options and interests similar to an option. For purposes of this paragraph (h), an option includes an interest similar to an option. Examples of options (including

interests similar to options) include, but are not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock or a partnership interest, a put, stock or a partnership interest subject to risk of forfeiture, a contract to acquire or sell stock or a partnership interest, and an exchangeable share or exchangeable partnership interest.

(6) Multiple claims on equity. Paragraph (h)(1) of this section shall not apply to an option to the extent treating the option as stock or a partnership interest would duplicate a shareholder's or partner's claim on the equity of the corporation or partnership by reason of holding stock in the corporation or an interest in the partnership. See Example 15 of paragraph (k) of this section for an illustration of the rules of this paragraph (h)(6).

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

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

(ii) Treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation under section 7874(a)(2)(B).

(2) Creditor claims--(i) Domestic corporation. For purposes of section 7874, if, immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then each creditor of the domestic corporation shall be treated as a shareholder of the domestic corporation and any claim of the creditor against the domestic corporation shall be treated as stock of the domestic corporation. See Example 19 of paragraph (k) of this section for an illustration of the rules of this paragraph (i)(2)(i).

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

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

§1.7874-1(c) and paragraph (f) of this section. See Example 19 of paragraph (k) of this section for an illustration of the rules of this paragraph (i)(2)(iii).

(j) Application of section 7874(b)--(1) Conversion to a domestic corporation.

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

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

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



this section. See Example 20 of paragraph (k) of this section for an illustration of the rules of this paragraph (j)(3).

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

(i) DC1 and DC2 are domestic corporations.

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

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

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

(v) Under the terms of the partnership agreements of DPS and FPS, each partner's share in the partnership's items of income, gain, deduction, and loss is determined in accordance with the partner's partnership interest percentage in the partnership, as stated in the examples.

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

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

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

(ix) All acquisitions of properties are completed after March 4, 2003.

(x) Section 7874(c)(4) does not apply, and no option is issued or acquired with a principal purpose to avoid a foreign corporation being treated as a surrogate foreign corporation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 7. Acquisition of multiple domestic corporations. (i) Facts. Individual A wholly owns DC1, and individual B wholly owns DC2. Pursuant to the same plan, individuals A and B transfer all of their DC1 stock and DC2 stock to FA, a newly formed corporation, in exchange solely for all 100 shares of FA stock outstanding.

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

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

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

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

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

Example 10. Incorporation of a partnership trade or business. (i) Facts. Individuals A and B equally own DPS. DPS transfers substantially all of its properties constituting a trade or business to FA, a newly formed corporation, solely in exchange for FA stock. DPS retains the FA stock after the transaction.

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

Example 11. Publicly traded foreign partnership treated as domestic corporation. (i) Facts. Pursuant to a plan, DC1 and individual B organize a limited liability company (HPS) under the law of Country A. DC1 owns 90% of the membership interests in HPS, and B owns 10% of the membership interests in HPS. HPS is a foreign eligible entity under §301.7701-2, and DC1 and B make an election under §301.7701-3 to treat HPS as a partnership for Federal tax purposes as of the date of the formation of HPS. HPS forms DC2. One day after the formation of HPS, DC2 merges with and into DC1. Pursuant to the merger agreement, the DC1 shareholders exchange their DC1 stock solely for membership interests in HPS. After the merger HPS wholly owns DC1, and the former shareholders of DC1 own a greater than 80% interest in HPS by reason of holding stock of DC1. Public trading of the HPS ownership interests begins the day after the date on which the merger is completed. HPS is not treated as a corporation under section 7704(a) by reason of section 7704(c). If HPS were a corporation, the condition of section 7874(a)(2)(B)(iii) would be satisfied.

(ii) Analysis. HPS is a publicly traded foreign partnership that is described in paragraph (g)(2) of this section. Therefore, under paragraph (g)(1) of this section, for purposes of section 7874, HPS is treated as a foreign corporation organized under the law of Country A and the membership interests in HPS are treated as stock of the foreign corporation. The foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, pursuant to the merger, HPS acquired substantially all of the properties held by DC1, the former shareholders of DC1 hold at least 60% of the stock of the foreign corporation by reason of holding stock of DC1, and the expanded affiliated group that includes the foreign corporation does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Further, because the former shareholders of DC1 hold at least 80% of the stock of the foreign corporation by reason of holding stock of DC1, section 7874(b) applies to the surrogate foreign corporation, and therefore HPS is treated as a domestic corporation for purposes of the Code. Under paragraph (g)(6) of this section, except for purposes of determining whether HPS is a surrogate foreign corporation, at the end of the day immediately preceding the date of the merger of DC2 with and into DC1, HPS is treated as transferring all of its assets and liabilities to a new domestic corporation in exchange solely for stock of the domestic corporation. HPS is then treated as proportionately distributing such stock to its membership interest holders in liquidation of the partnership. In addition, as a result of the merger of DC2 with and

into DC1, the former shareholders of DC1 shall be treated as receiving stock of a domestic corporation in exchange for their DC1 stock.

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

(ii) Analysis. Under paragraph (g)(1) of this section, for purposes of section 7874, HPS is treated as a foreign corporation and the membership interests in HPS are treated as stock of the foreign corporation. However, the foreign corporation is not treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, after the acquisition, the expanded affiliated group that includes HPS has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Therefore, under paragraph (g)(5) of this section, section 7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under section 7874(a) by reason of the acquisition.

Example 13. Publicly traded foreign partnership treated as a surrogate foreign corporation but not as a domestic corporation. (i) Facts. FPS is a publicly traded foreign partnership organized in Country A that, by reason of section 7704(c), is not treated as a corporation under section 7704(a). FPS acquires all the stock of DC1 in exchange for partnership interests in FPS. After the acquisition, the former shareholders of DC1 hold a 75%-interest in FPS by reason of holding DC1 stock. After the acquisition, the expanded affiliated group that includes FPS (treated as a foreign corporation for this purpose) does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

(ii) Analysis. Under paragraph (g)(1) of this section, for purposes of section 7874, FPS is treated as a foreign corporation and the partnership interests in FPS are treated as stock of the foreign corporation. FPS is treated as a surrogate foreign corporation because the conditions of section 7874(a)(2)(B) are satisfied. However, because the former shareholders of DC1 hold less than an 80%-interest in FPS by reason of holding DC1 stock, section 7874(b) does not apply to FPS. Therefore, under paragraph (g)(4) of this section FPS continues to be treated as a foreign partnership for purposes of the Code, but section 7874(a)(1) applies to DC1 and any other expatriated entity.

Example 14. Warrant to acquire stock from the foreign corporation. (i) Facts. Individual A wholly owns DC1. DC1 has a \$200x value. Individual B wholly owns FA. The value of B's FA stock is \$400x. Individual C holds a warrant to acquire FA stock from FA at an exercise price of \$20x. Individual A transfers all of its DC1 stock to FA in

exchange solely for FA stock with a value of \$200x. At the time of the transfer, the FA stock that individual C can acquire pursuant to the warrant has a \$70x value.

(ii) Analysis. Under paragraphs (h)(1) of this section, for purposes of section 7874, individual C is treated as owning FA stock with a \$50x value. This amount represents individual C's claim on the equity of FA after the acquisition (\$70x value of FA stock that may be acquired pursuant to the warrant, less the \$20x exercise price), without taking into account the \$20x individual C would be required to provide to FA upon the exercise of the warrant. Thus, for purposes of section 7874, the value of the stock of FA immediately after the transaction is \$650x (\$600x of FA stock, plus C's \$50x claim on the equity of FA). C's warrant is not taken into account for purposes of determining the voting power of FA under section 7874.

Example 15. Option to acquire stock from another shareholder. (i) Facts. The facts are the same as in Example 14 except that, instead of holding a warrant issued by FA, individual C holds an option to acquire FA stock from individual B for an exercise price of \$20x. At the time of the acquisition, the FA stock that individual C can acquire under the option has a \$70x value.

(ii) Analysis. Under paragraph (h)(6) of this section, for purposes of section 7874, individual C is not treated as owning FA stock by reason of holding the option because treating the option as FA stock would have the effect of partially duplicating individual B's claim on the equity of FA at the time of the acquisition by reason of holding FA stock. However, all of the FA stock owned by individual B will be taken into account for purposes of section 7874. C's warrant is not taken into account for purposes of determining voting power of FA under section 7874.

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

(ii) Analysis. Under paragraphs (h)(1) of this section, for purposes of section 7874, the warrant held by the DC1 employee is treated as DC1 stock with a value equal to the employee's claim on the equity of DC1 immediately before the acquisition. Further, for purposes of section 7874, the DC1 employee is treated as holding FA stock with a value equal to the employee's claim on the equity of FA after the acquisition by reason of holding the warrant to acquire DC1 stock (treated as DC1 stock for this purpose). The option held by the DC1 employee is not taken into account for purposes of determining the voting power of FA under section 7874.

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

stock of DC2. DC2 merges with and into DC1 with DC1 surviving. Pursuant to the merger agreement, individuals A and B exchange their DC1 stock for cash and shares of class B stock of DC1. Following the merger FA owns all the class A stock of DC1. FA does not hold significant assets other than the class A stock of DC1. Individuals A and B own all the class B stock of DC1. DC1 has no other class of stock outstanding.

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

(ii) Analysis. The dividend rights provided by the class B stock are substantially similar in all material respects to the dividend rights provided by the FA stock. In addition, because FA does not hold significant assets other than the class A stock, the value of the class B stock held by individuals A and B is approximately equal to the value of a corresponding amount of publicly traded FA stock. The distribution rights on liquidation (or redemption) provided by the class B stock, therefore, are substantially similar in all material respects to the distribution rights on liquidation (or redemption) provided by the FA stock. As a result, the distribution rights provided by the class B stock are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. Thus, if treating the class B stock as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (i)(1) of this section the class B stock will be treated as FA stock for purposes of section 7874.

Example 18. Partnership interest treated as stock of foreign acquiring corporation. (i) Facts. (A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. Individuals A and B and FA organize FPS. FA transfers part of the cash from the public offering to FPS in exchange for a class A partnership interest. FA does not hold any significant assets other than the class A partnership interest. Individuals A and B transfer their DC1 stock to FPS in exchange for class B partnership interests.

(B) The class B partnership interests entitle individuals A and B to cash distributions from FPS approximately equal to any dividend distributions made by FA with respect to its publicly traded stock. In certain circumstances, the class B partnership interests also permit individuals A and B to require FPS to redeem the interests in exchange for cash equal to the value of an amount of FA stock as determined on the redemption date. The class B partnership interests do not provide individuals A or B voting rights with respect to FA.

(ii) Analysis. The non-liquidating distribution rights provided by the class B partnership interests are substantially similar in all material respects to the dividend rights provided by the FA stock. Because FA does not hold any significant assets other than the class A partnership interest, the value of the class B partnership interests held

by individuals A and B is approximately equal to a corresponding amount of FA stock. The distribution rights on liquidation (or redemption) provided by the class B partnership interests, therefore, are substantially similar in all material respects to distribution rights on liquidation (or redemption) provided by the FA stock. Thus, the distribution rights provided by the class B partnership interests are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. As a result, if treating the class B partnership interests as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (i)(1) of this section the class B partnership interests will be treated as FA stock for purposes of section 7874.

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

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

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

(ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring all of the properties held by DC1 on the date of the stock acquisition. After the acquisition, the former shareholders of DC1 own 80% of the stock of FA by reason of holding DC1 stock. Therefore, FA is a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b). Under paragraph (j)(1) of this section, except for purposes of determining whether FA is treated as a surrogate foreign corporation, the conversion of FA to a domestic corporation constitutes a reorganization described in section 368(a)(1)(F) that occurs at the end of the day immediately preceding the date of the stock acquisition. Section 367 applies to the conversion of FA to a domestic corporation. See, for example, §§1.367(b)-2 and 1.367(b)-3 for the consequences of the conversion. Under paragraph (j)(3) of this section, section 367 does not apply to the transfers of DC1 stock by individuals A and B to FA.



(l) Effective/applicability date. This section applies to acquisitions completed on or after **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**. For acquisitions completed prior to **[INSERT DATE THIS DOCUMENT IS FILED FOR PUBLIC INSPECTION BY THE FEDERAL REGISTER]**, see §1.7874-2T(o), as contained in 26 CFR part 1, revised as of April 1, 2012.

**§1.7874-2T [Removed]**

Par. 5. Section 1.7874-2T is removed.

Steven T. Miller,  
Deputy Commissioner for Services and Enforcement.

Approved: June 4, 2012.

Emily S. McMahon,  
Acting Assistant Secretary of the Treasury (Tax Policy).

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