

stock as follows: (i) 70 shares directly, and (ii) 15 shares constructively, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 30 shares owned directly by Y. Since A's percentage of ownership of X's voting stock after the sale (85 out of 200 shares, or 42.5%) is not less than 80 percent of his percentage of ownership of X's voting stock before the sale (100 out of 200 shares, or 50%), the transfer is not "substantially disproportionate" as to him as provided in section 302(b)(2). Under these facts, and assuming that section 302(b)(1) is not applicable, the entire \$50,000 is treated as a dividend to A to the extent of the earnings and profits of corporation Y. The basis of the corporation X stock to corporation Y is \$10,000, its adjusted basis to A. The amount of \$10,000 is added to the basis of the stock of corporation Y in the hands of A.

Example (2). The facts are the same as in *Example (1)* except that A sells 80 shares of corporation X stock to corporation Y, and the sale occurs before August 31, 1964. After the sale, A is considered as owning corporation X stock as follows: (i) 20 shares directly, and (ii) 90 shares indirectly, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 80 shares owned directly by Y and 50 percent of the 100 shares attributed to Y because they are owned by Y's stockholder, B. Since after the sale A owns a total of more than 50 percent of the voting power of all of the outstanding stock of X (110 out of 200 shares, or 55%), the transfer is not "substantially disproportionate" as to him as provided in section 302(b)(2).

Example (3). Corporation X and corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half the stock of corporation X, and C owns one-half the stock of corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of corporation X to corporation Y for \$50,000, such stock having an adjusted basis of \$10,000 to him. After the sale, A is considered as owning 35 shares of the stock of corporation X (20 shares directly and 15 constructively because one-half of the 30 shares owned by corporation Y are attributed to him). Since before the sale he owned 50 percent of the stock of corporation X and after the sale he owned directly and constructively only 35 percent of such stock, the redemption is substantially disproportionate as to him pursuant to the provisions of section 302(b)(2). He, therefore, realizes a gain of \$40,000 (\$50,000 minus \$10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of corporation Y is not changed as a result of the entire transaction. The basis to corporation Y for the stock of corporation X is \$50,000, i.e., the basis of the transferor (\$10,000), increased in

the amount of gain recognized to the transferor (\$40,000) on the transfer.

Example (4). Corporation X and corporation Y each have outstanding 100 shares of common stock. H, an individual, W, his wife, S, his son, and G, his grandson, each own 25 shares of stock of each corporation. H sells all of his 25 shares of stock of corporation X to corporation Y. Since both before and after the transaction H owned directly and constructively 100 percent of the stock of corporation X, and assuming that section 302(b)(1) is not applicable, the amount received by him for his stock of corporation X is treated as a dividend to him to the extent of the earnings and profits of corporation Y.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11997, Aug. 23, 1968]

§ 1.304-3 Acquisition by a subsidiary.

(a) If a subsidiary acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as though the parent corporation had redeemed its own stock. For the purpose of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. If such distribution would have been treated as a distribution of property (pursuant to section 302(d)) under section 301, the entire amount of the selling price of the stock shall be treated as a dividend to the seller to the extent of the earnings and profits of the parent corporation determined as if the distribution had been made to it of the property that the subsidiary exchanged for the stock. In such cases, the transferor's basis for his remaining stock in the parent corporation will be determined by including the amount of the basis of the stock of the parent corporation sold to the subsidiary.

(b) Section 304(a)(2) may be illustrated by the following example:

Example. Corporation M has outstanding 100 shares of common stock which are owned as follows: B, 75 shares, C, son of B, 20 shares, and D, daughter of B, 5 shares. Corporation M owns the stock of Corporation X. B sells

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his 75 shares of Corporation M stock to Corporation X. Under section 302(b)(3) this is a termination of B's entire interest in Corporation M and the full amount received from the sale of his stock will be treated as payment in exchange for this stock, provided he fulfills the requirements of section 302(c)(2) (relating to an acquisition of an interest in the corporations).

§ 1.304-4T Special rule for use of a related corporation to acquire for property the stock of another commonly owned corporation (temporary).

(a) *In general.* At the discretion of the District Director, for purposes of determining the amount constituting a dividend, and source thereof, under section 304(b)(2), a corporation (deemed acquiring corporation) will be considered to have acquired for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if one of the principal purposes for creating, organizing, or funding the acquiring corporation, through capital contributions or debt, is to avoid the application of section 304 to the deemed acquiring corporation. The following example illustrates the application of this paragraph (a).

Example. P, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation with substantial accumulated earnings and profits. CFC1 is organized in Country X, which imposes a high rate of tax on CFC1's income. P also owns all of the stock of CFC2, another controlled foreign corporation, which has accumulated earnings and profits of \$200x. CFC2 is organized in Country Y which imposes a low rate of tax on CFC2's income. P wishes to own all of its foreign corporations in a direct chain and to effectuate a repatriation of CFC2's cash to P. In order to avoid having to obtain Country X approval for the acquisition of CFC1 (a Country X corporation) by CFC2 (a Country Y corporation) and to avoid a dividend to P out of CFC2's earnings and profits that would otherwise occur as a result of the application of section 304, P causes CFC2 to form RFC as a Country X wholly-owned subsidiary and to contribute \$100x to RFC. RFC will purchase, for \$100x, all of the stock of CFC1 from P. Because one of P's principal purposes for having CFC1 owned by RFC is to avoid section 304, under § 1.304-4T(a), CFC2 is considered to have acquired the stock of CFC1 for \$100x for purposes of determining the amount consti-

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tuting a dividend (and source thereof) for purposes of section 304(b)(2).

(b) *Availability to taxpayers.* Nothing in this regulation shall be construed to provide a taxpayer the right to compel the Internal Revenue Service to disregard the form of its transaction for Federal income tax purposes.

(c) *Effective date.* This section is effective June 14, 1988, with respect to acquisitions of stock occurring on or after June 14, 1988.

[T.D. 8209, 53 FR 22171, June 14, 1988]

§ 1.304-5 Control.

(a) *Control requirement in general.* Section 304(c)(1) provides that, for purposes of section 304, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Section 304(c)(3) makes section 318(a) (relating to constructive ownership of stock), as modified by section 304(c)(3)(B), applicable to section 304 for purposes of determining control under section 304(c)(1).

(b) *Effect of section 304(c)(2)(B)—(1) In general.* In determining whether the control test with respect to both the issuing and acquiring corporations is satisfied, section 304(a)(1) considers only the person or persons that—

(i) Control the issuing corporation before the transaction;

(ii) Transfer issuing corporation stock to the acquiring corporation for property; and

(iii) Control the acquiring corporation thereafter.

(2) *Application.* Section 317 defines property to include money, securities, and any other property except stock (or stock rights) in the distributing corporation. However, section 304(c)(2)(B) provides a special rule to extend the relevant group of persons to be tested for control of both the issuing and acquiring corporations to include the person or persons that do not acquire property, but rather solely stock from the acquiring corporation in the transaction. Section 304(c)(2)(B) provides that if two or more persons in control of the issuing corporation transfer stock of such corporation to