

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

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

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

Paragraph (p) of this section provides the expiration date of this section.

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

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

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

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

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

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

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

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

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

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

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

(9) The determination of whether a foreign corporation is a surrogate foreign corporation is made after the acquisition described in section

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

(c) *Acquisition of properties*—(1) *Indirect acquisition of properties*. For purposes of section 7874(a)(2)(B)(i), an indirect acquisition of properties held by a domestic corporation (or of a partnership) includes the acquisitions described in paragraphs (c)(1)(i) through (iv) of this section. An acquisition of less than all of the stock of a domestic corporation (or interests in a partnership) shall constitute an indirect acquisition of a proportionate amount of the properties held by the domestic corporation or of the partnership. See paragraph (b)(8) of this section for rules determining the proportionate amount of properties indirectly acquired.

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

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

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

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

acquisition by the foreign issuing corporation.

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

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

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

(f) *Stock held by reason of holding stock in a domestic corporation or an interest in a domestic partnership*—(1) *Specified transactions*. For purposes of section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or

an interest in a domestic partnership) includes the stock described in paragraphs (f)(1)(i) through (iii) of this section.

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

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

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

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

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

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

(g) *Substantial business activities*—(1) *General rule.* The determination of whether, after the acquisition, the expanded affiliated group that includes the foreign corporation has substantial

business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized when compared to the total business activities of the expanded affiliated group, is (subject to paragraph (g)(5) of this section) based on all facts and circumstances.

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

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

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

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

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

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

(C) Sales of goods to customers.

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

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

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

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

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

(i) Any business activities or income attributable to properties or liabilities the transfer of which is disregarded under section 7874(c)(4).

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

(iii) Any assets, business activities, or employees located in the foreign country in which, or under the law of

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

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

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

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

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

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

of the publicly traded foreign partnership to a domestic corporation. See *Example 11* of paragraph (n) of this section for an illustration of the rules of this paragraph.

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

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

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

evant provisions of the Code and general tax principles.

(i) [Reserved]

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

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

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

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

(4) *Multiple claims on equity.* Paragraphs (j)(1) and (j)(2)(i) of this section shall not apply to an option (or similar interest) to the extent treating the option (or similar interest) as stock of a corporation (or interest in a partnership) would duplicate a shareholder's (or partner's) claim on the equity of the corporation (or partnership) by reason of holding stock in the corporation (or an interest in the partnership). However, except to the extent otherwise provided in section 7874, in all cases stock of a corporation held by a shareholder or an interest in a partnership held by a partner (without regard to this paragraph (j)) shall be taken into account for purposes of section 7874. See *Example 15* of paragraph (n) of this section for an illustration of the rules of this paragraph (j)(4).

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

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

resent a return on, or of, the holder's investment in the interest.

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

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

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

(iii) *Treatment of creditor as shareholder or partner.* A creditor that is treated as a shareholder or partner under paragraph (k)(2)(i) or (ii) of this section shall be treated as a shareholder or partner for all purposes of section 7874. See, for example, § 1.7874-1(c) and paragraph (f) of this section. See *Example 19* of paragraph (n) of this section for an illustration of the rules of this paragraph (k)(2)(iii).

(l) [Reserved]

(m) *Application of section 7874(b)—*(1) *Conversion to a domestic corporation.* Except for purposes of determining whether a foreign corporation is treated as a surrogate foreign corporation, the conversion of a foreign corporation to a domestic corporation by reason of

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

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

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

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

(i) DC1 and DC2 are domestic corporations.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) *Analysis.* Under paragraph (c)(1)(i) of this section, in the aggregate F1, F2, F3 and

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

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

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

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

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

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

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

value of the DC1 stock to all the property transferred by A to FA).

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

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

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

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

*Example 11. Publicly traded foreign partnership treated as domestic corporation.* (i) *Facts.* Pursuant to a plan, DC1 and individual B organize a limited liability company (HPS) under the law of Country A. DC1 owns 99.9 percent of the membership interests in HPS, and B owns 0.1 percent of the membership interests in HPS. HPS is a foreign eligible entity under §301.7701-2 of this chapter, and DC1 and B make an election under §301.7701-3 of this chapter to treat HPS as a partnership for Federal tax purposes as of the date of the formation of HPS. HPS forms DC2. DC2 merges with and into DC1. Pursuant to the merger agreement, the DC1 shareholders exchange their DC1 stock solely for membership interests in HPS. After the merger HPS wholly owns DC1, and the former shareholders of DC1 own a greater than 80 percent interest in HPS by reason of holding stock of DC1. Public trading of the HPS ownership interests begins the day after the date on which merger is completed. HPS is not treated as a corporation under section 7704(a) by reason of section 7704(c). If HPS were a corporation, the condition of section 7874(a)(2)(B)(iii) would be satisfied.

(ii) *Analysis.* HPS is a publicly traded foreign partnership that is described in paragraph (h)(2) of this section. Therefore, under paragraph (h)(1) of this section, for purposes of section 7874 HPS is treated as a foreign

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

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

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

*Example 13. Publicly traded foreign partnership treated as a surrogate foreign corporation*

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

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

*Example 14. Warrant to acquire stock from the foreign corporation.* (i) *Facts.* Individual A wholly owns DC1. DC1 has a \$200x value. Individual B wholly owns FA. Individual C holds a warrant to acquire FA stock from FA at an exercise price of \$20x. Individual A transfers all of its DC1 stock to FA in exchange solely for FA stock. At the time of the transfer, the FA stock that individual C can acquire pursuant to the warrant has a \$70x value.

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

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

(ii) *Analysis.* Under paragraph (j)(4) of this section, for purposes of section 7874, individual C is not treated as owning FA stock by reason of holding the option because treating the option as FA stock would have

the effect of partially duplicating individual B's claim on the equity of FA at the time of the acquisition by reason of holding FA stock. However, all of the FA stock owned by individual B shall be taken into account for purposes of section 7874.

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

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

*Example 17. Stock in a subsidiary treated as stock of a foreign parent corporation.* (i) *Facts.* (A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. FA contributes part of the cash from the public offering to DC2, a newly-formed corporation, in exchange for all the stock of DC2. DC2 merges with and into DC1 with DC1 surviving. Pursuant to the merger agreement, individuals A and B exchange their DC1 stock for cash and shares of class B stock of DC1. Following the merger FA owns all the class A stock of DC1. FA holds few assets other than the class A stock of DC1. Individuals A and B own all the class B stock of DC1. DC1 has no other class of stock outstanding.

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

(ii) *Analysis.* The dividend rights provided by the class B stock are substantially similar in all material respects to the dividend rights provided by the FA stock. In addition, because FA holds few assets other than the class A stock, the value of the class B stock held by individuals A and B is approximately equal to the value of a corresponding amount of publicly traded FA stock. The distribution rights on liquidation (or redemption) provided by the class B stock, therefore, are substantially similar in all material respects

to the distribution rights on liquidation (or redemption) provided by the FA stock. As a result, the distribution rights provided by the class B stock are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. Thus, if treating the class B stock as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (k)(1) of this section the class B stock shall be treated as FA stock for purposes of section 7874.

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

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

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

*Example 19. Creditor treated as a shareholder.* (i) *Facts.* Individuals A and B equally own DC1. The liabilities of DC1 exceed the value of its assets. Pursuant to a plan, FA, a

newly-formed corporation, acquires substantially all of the properties held by DC1 in exchange solely for FA stock. Pursuant to the plan, the DC1 stock held by individuals A and B is cancelled, and the creditors of DC1 receive all the FA stock in exchange for their claims against DC1.

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

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

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

(o) *Effective/applicability date*—(1) *Temporary regulations filed on June 9, 2009.* This section shall apply to acquisitions completed on or after June 9, 2009. However, taxpayers may apply this section to acquisitions completed before June 9, 2009, if this section is ap-

plied consistently to all acquisitions completed before such date.

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

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

[T.D. 9453, 74 FR 27926, June 12, 2009]

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SOURCE: Sections 1.9000-1 through 1.9000-8 contained in T.D. 6500, 25 FR 12155, Nov. 26, 1960, unless otherwise noted.

**§ 1.9000-1 Statutory provisions.**

The Act of June 15, 1955 (Pub. L. 74, 84th Cong., 69 Stat. 134), provides as follows:

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

SECTION 1. *Repeal of sections 452 and 462—(a) Prepaid income.* Section 452 of the Internal Revenue Code of 1954 is hereby repealed.

(b) Reserves for estimated expenses, etc. Section 462 of the Internal Revenue Code of 1954 is hereby repealed.

SEC. 2. *Technical amendments.* The following provisions of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Subsection (c) of section 381 is amended by striking out paragraph (7) (relating to carryover of prepaid income in certain corporate acquisitions).

(2) The table of sections for subpart B of part II of subchapter E of chapter 1 (relating to taxable year for which items of gross income included) is amended by striking out "Sec. 452. Prepaid income."

(3) The table of sections for subpart C of such part II (relating to taxable year for