(2) *Exception.* A taxpayer may, however, elect to have §§1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur (or occurred) before February 23, 2000, if the due date for the taxpayer's timely filed Federal tax return (including extensions) for the taxable year in which the section 367(b) exchange occurs (or occurred) is after February 23, 2000. The election under this paragraph (a)(2) will be valid only if—

(i) The electing taxpayer makes the election on a timely filed section 367(b) notice;

(ii) In the case of an exchanging shareholder that is a foreign corporation, the election is made on the section 367(b) notice that is filed by each of its shareholders listed in §1.367(b)–1(c)(3)(ii); and

(iii) The electing taxpayer provides notice of the election to all corporations (or their successors in interest) whose earnings and profits are affected by the election on or before the date the section 367(b) notice is filed.

(b) *Certain recapitalizations described in §1.367(b)–4(b)(3).* In the case of a recapitalization described in §1.367(b)–4(b)(3) that occurred prior to July 20, 1998, the exchanging shareholder shall include the section 1248 amount on its tax return for the taxable year that includes the exchange described in §1.367(b)–4(b)(3)(i) (and not in the taxable year of the recapitalization), except that no inclusion is required if both the recapitalization and the exchange described in §1.367(b)–4(b)(3)(i) occurred prior to July 20, 1998.

(c) *Use of reasonable method to comply with prior published guidance*—(1) *Prior exchanges.* The taxpayer may use a reasonable method to comply with the following prior published guidance to the extent such guidance relates to section 367(b): Notice 88–71 (1988–2 C.B. 374); Notice 89–30 (1989–1 C.B. 670); and Notice 89–79 (1989–2 C.B. 392) (see §601.601(d)(2) of this chapter). This rule applies to section 367(b) exchanges that occur (or occurred) before February 23, 2000, or, if a taxpayer makes the election described in paragraph (a)(2) of this section, for section 367(b) exchanges that occur (or occurred) before the date described in paragraph (a)(2) of this section. This rule also applies to section 367(b) exchanges and distributions described in paragraph (d) of this section.

(2) *Future exchanges.* Section 367(b) exchanges that occur on or after February 23, 2000, (or, if a taxpayer makes the election described in paragraph (a)(2) of this section, for section 367(b) exchanges that occur on or after the date described in paragraph (a)(2) of this section) are governed by the section 367(b) regulations and, as a result, paragraph (c)(1) of this section shall not apply.

(d) *Effect of removal of attribution rules.* To the extent that the rules under §§7.367(b)–9 and 7.367(b)–10(h) of this chapter, as in effect prior to February 23, 2000 (see 26 CFR part 1, revised as of April 1, 1999), attributed earnings and profits to the stock of a foreign corporation in connection with an exchange described in section 351, 354, 355, or 356 before February 23, 2000, the foreign corporation shall continue to be subject to the rules of §7.367(b)–12 of this chapter in the event of any subsequent exchanges and distributions with respect to such stock, notwithstanding the fact that such subsequent exchange or distribution occurs on or after the effective date described in paragraph (a) of this section.

[T.D. 8862, 65 FR 3608, Jan. 24, 2000, as amended by T.D. 9243, 71 FR 4289, Jan. 26, 2006; T.D. 9250, 71 FR 8805, Feb. 21, 2006; T.D. 9243, 71 FR 28266, May 16, 2006; T.D. 9273, 71 FR 44895, Aug. 8, 2006; 73 FR 14386, Mar. 18, 2008]

## § 1.367(b)–7 Carryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

(a) *Scope.* This section applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign section 381 transaction). This section describes the manner and extent to which earnings and profits and foreign income taxes of the foreign acquiring corporation and the foreign target corporation carry over to the surviving foreign corporation (foreign surviving corporation) and the ordering of distributions by the foreign surviving corporation. See §1.367(b)–9 for special rules governing reorganizations described in section 368(a)(1)(F) and foreign section 381 transactions involving foreign corporations that hold no property and have no tax attributes immediately before the transaction, other than a nominal amount of assets (and related tax attributes).

(b) *General rules*—(1) *Non-previously taxed earnings and profits and related taxes.* Earnings and profits and related foreign income taxes of the foreign acquiring corporation and the foreign target corporation (pre-transaction earnings and pre-transaction taxes, respectively) shall carry over to the foreign surviving corporation in the manner described in paragraphs (d), (e), and (f) of this section. Dividend distributions by the foreign surviving corporation (post-transaction distributions) shall be out of earnings and profits and shall reduce related foreign income taxes in the manner described in paragraph (c) of this section.

(2) *Previously taxed earnings and profits.* [Reserved]

(c) *Ordering rule for post-transaction distributions.* Dividend distributions out of a foreign surviving corporation's earnings and profits shall be ordered in accordance with the rules of paragraph (c)(1) or (2) of this section, depending on whether the foreign surviving corporation is a pooling corporation or a nonpooling corporation.

(1) *If foreign surviving corporation is a pooling corporation.* In the case of a foreign surviving corporation that is a pooling corporation, post-transaction distributions shall be first out of the post-1986 pool (as described in paragraph (d) of this section) and second out of the pre-pooling annual layers (as described in paragraph (e)(1) of this section) under an annual last-in, first-out (LIFO) method.

(2) *If foreign surviving corporation is a nonpooling corporation.* In the case of a foreign surviving corporation that is a nonpooling corporation, post-transaction distributions shall be out of the pre-pooling annual layers (as described in paragraph (e)(2) of this section) under the LIFO method.

(d) *Post-1986 pool.* If the foreign surviving corporation is a pooling corporation, then the post-1986 pool shall be determined under the rules of this paragraph (d).

(1) *In general*—(i) *Qualifying earnings and taxes.* The post-1986 pool shall consist of the post-1986 undistributed earnings and related post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) *Carryover rule.* Subject to paragraph (d)(2) of this section, the amounts described in paragraph (d)(1)(i) of this section attributable to the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation and shall be combined on a separate category-by-separate category basis.

(2) *Hovering deficit*—(i) *In general.* If immediately prior to the foreign section 381 transaction either the foreign acquiring corporation or the foreign target corporation has a deficit in one or more separate categories of post-1986 undistributed earnings or an aggregate deficit in pre-1987 accumulated profits, such deficit will be a hovering deficit of the foreign surviving corporation. The rules of this paragraph (d)(2) apply to hovering deficits in separate categories of post-1986 undistributed earnings. See paragraphs (e)(1)(iii) and (e)(2)(iii) of this section for rules that apply to hovering deficits in pre-1987 accumulated profits. If the foreign acquiring corporation and the foreign target corporation each have a post-1986 hovering deficit in the same separate category of post-1986 undistributed earnings, such deficits and their related post-1986 foreign income taxes shall be combined for purposes of applying this paragraph (d)(2). See also paragraphs (f)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (d)(2)).

(ii) *Offset rule.* A hovering deficit in a separate category of post-1986 undistributed earnings shall offset only earnings and profits accumulated by the foreign surviving corporation after the foreign section 381 transaction (post-transaction earnings) in the same separate category of post-1986 undistributed earnings. For purposes of this rule, however, post-transaction earnings do not include post-1986 undistributed earnings in the same category that are earned after the foreign section 381 transaction, but are distributed or deemed distributed in the same year they are earned (that is, that do not become accumulated). The offset shall occur as of the first day of the foreign surviving corporation's first taxable year following the year in which the post-transaction earnings accumulated.

(iii) *Related taxes.* Post-1986 foreign income taxes that are related to a hovering deficit in a separate category of post-1986 undistributed earnings shall only be added to the foreign surviving corporation's post-1986 foreign income taxes in that separate category on a pro rata basis as the hovering deficit is absorbed. Pro rata means in the same proportion as the portion of the hovering deficit that offsets post-transaction earnings in the separate category under paragraph (d)(2)(ii) of this section bears to the total amount of the hovering deficit.

(3) *Examples.* The following examples illustrate the rules of this paragraph (d). The examples assume the following facts: Foreign corporations A and B are controlled foreign corporations (CFCs) that were incorporated after December 31, 1986, have always been pooling corporations, and have always had calendar taxable years. None of the shareholders of foreign corporations A and B are required to include any amount in income under §1.367(b)–4 as a result of the foreign section 381 transaction. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a ''u'' functional currency. Finally, unless otherwise stated, any post-1986 undistributed earnings in the passive category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled section 902 corporation and that qualified for the subpart F same-country exception under section 954(c)(3)(A). The examples are as follows:

*Example 1.* (i) *Facts.* (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| **Foreign Corporation A** | | |
| General | 300u | $60 |
| Passive | 100u | 40 |
| | 400u | $100 |
| **Foreign Corporation B** | | |
| General | 300u | $70 |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* Under the rules described in paragraph (d)(1) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| General | 600u | $130 |
| Passive | 100u | 40 |
| | 700u | $170 |

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 350u to its shareholders. Under the rules described in §1.902–1(d)(1) and paragraph (c)(1) of this section, the distribution is out of, and reduces, post–1986 undistributed earnings and post-1986 foreign income taxes in the separate categories on a pro rata basis, as follows:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| General | 300u | $65 |
| Passive | 50u | 20 |
| | 350u | $85 |

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| General | 300u | $65 |
| Passive | 50u | 20 |

| Separate category | E&P | Foreign taxes |
|---|---|---|
| | 350u | $85 |

*Example 2.* (i) *Facts.* (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| **Foreign Corporation A** | | |
| General | 200u | $30 |
| Passive | (100u) | 10 |
| | 100u | $40 |
| **Foreign Corporation B** | | |
| General | 300u | $60 |
| Passive | 100u | 30 |
| | 400u | $90 |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 500u | | $ 90 | |
| Passive | 100u | (100u) | 30 | $10 |
| | 600u | (100u) | $120 | $10 |

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 300u to its shareholders. Under the rules described in §1.902–1(d)(1) and paragraph (c)(1) of this section, the distribution is out of, and reduces, post-1986 undistributed earnings and post-1986 foreign income taxes on a pro rata basis as follows:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| General | 250u | $45 |
| Passive | 50u | 15 |
| | 300u | $60 |

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 250u | | $45 | |
| Passive | 50u | (100u) | 15 | $10 |
| | 300u | (100u) | $60 | $10 |

(iv) *Post-transaction earnings*—(A) In its taxable year ending on December 31, 2008, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| General | 100u | $20 |
| Passive | 50u | $10 |
| | 150u | $40 |

(B) None of foreign surviving corporation's earnings and profits for its 2008 taxable year qualifies as subpart F income as defined in section 952(a). Under the rules described in paragraphs (d)(2)(ii) and (iii) of this section, the hovering deficit in the passive category will offset the post-transaction earnings in that category and a proportionate amount of the foreign taxes related to the hovering deficit will be added to the post-1986 foreign income taxes pool. Because the post-transaction earnings in the passive category are half of the amount of the hovering deficit, half of the related taxes are added to the post-1986 foreign income taxes pool. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2009:

| Separate category | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 350u | | $65 | |
| Passive | 50u | (50u) | 30 | $5 |
| | 400u | (50u) | $95 | $5 |

*Example 3*. (i) *Facts*. The facts are the same as *Example 2*, except that the 50u of earnings in the passive category accrued by foreign surviving corporation during 2008 is subpart F income, all of which is included in income under section 951(a) by United States shareholders (as defined in section 951(b)). This example assumes that none of the United States shareholders are able to reduce their subpart F income inclusion with a qualified deficit under section 952(c)(1)(B).

(ii) *Result*. (A) Under the rule described in paragraph (f)(1) of this section, the (100u) hovering deficit in the passive category does not reduce foreign surviving corporation's current passive earnings and profits for purposes of determining subpart F income or associated deemed paid credits. Thus, foreign surviving corporation's United States shareholders include their pro rata shares of 50u in taxable income for the year and are eligible for a deemed paid foreign tax credit under section 960, computed by reference to their pro rata shares of $12.50 (50u subpart F inclusion / (50u + 50u post-1986 undistributed earnings in the passive category = 100u) = 50%, × $25 post-1986 foreign income taxes in the passive category = $12.50). The United States shareholders will also include their pro rata shares of the deemed-paid taxes of $12.50 in taxable income for the year as a deemed dividend pursuant to section 78.

(B) Immediately after the subpart F inclusion and section 960 deemed paid taxes (and taking into account the taxable year 2008 earnings and profits and related taxes in the general category), foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | Earnings & profits | | Foreign taxes available | Foreign taxes |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | | Foreign taxes associated with hovering deficit |
| General | 350u | | $65.00 | |
| Passive | 50u | (100u) | 12.50 | $10 |
| | 400u | (100u) | 77.50 | 10 |

(C) The 50u included as subpart F income constitutes previously taxed earnings and profits under section 959.

*Example 4.* (i) *Facts.* (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | E&P | Foreign taxes |
|---|---|---|
| **Foreign Corporation A** | | |
| General | 50u | $10 |
| **Foreign Corporation B** | | |
| General | (100u) | $20 |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* (A) Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | Earnings & profits | | Foreign taxes available | Foreign taxes |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | | Foreign taxes associated with hovering deficit |
| General | 50u | (100u) | $10 | $20 |

(iii) *Post-transaction earnings and distribution.* (A) In its taxable year ending on December 31, 2007, foreign surviving corporation earns 100u in the general category and pays related foreign income taxes of $24. On December 31, 2007, foreign surviving corporation distributes 75u to its shareholders.

(B) *Result.* For purposes of determining the dividend amount under section 316 and the foreign income taxes deemed paid with respect to that dividend under section 902, under paragraph (d)(2)(ii) of this section the hovering deficit does not offset the post-transaction current year earnings. Accordingly, the full 75u will be a dividend under section 316. The deemed paid taxes on that dividend are $17 (75u distribution / (100u current earnings + 50u accumulated earnings) = 50%, × ($10 accumulated foreign taxes + $24 current year foreign taxes) = $17). The 25u of undistributed earnings and profits in 2007 will be offset by (25u) of the hovering deficit for purposes of determining the opening balance of the post-1986 undistributed earnings pool in 2008. Because the amount of earnings offset by the hovering deficit is 25% of the amount of the hovering deficit, under paragraph (d)(2)(iii) of this section $5 (25% of $20) of the related taxes are added to the post-1986 foreign income taxes pool at the beginning of the next taxable year. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2008:

| Separate category | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 50u | (75u) | $22 | $15 |

(e) *Pre-pooling annual layers*—(1) *If foreign surviving corporation is a pooling corporation.* If the foreign surviving corporation is a pooling corporation, the pre-pooling annual layers shall be determined under the rules of this paragraph (e)(1).

(i) *Qualifying earnings and taxes.* The pre-pooling annual layers shall consist of the pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) *Carryover rule.* Subject to paragraph (e)(1)(iii) of this section, the amounts described in paragraph (e)(1)(i) of this section shall carry over to the foreign surviving corporation but shall not be combined. If the foreign acquiring corporation and the foreign target corporation have pre-1987 accumulated profits in the same year and a distribution is made therefrom, the rules of §1.902–1(b)(2)(ii) and (b)(3) shall apply separately to reduce pre-1987 accumulated profits and pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Rev. Rul. 68–351 (1968–2 C.B. 307); Rev. Rul. 70–373 (1970–2 C.B. 152) (see also §601.601(d)(2) of this chapter); see also paragraph (f)(2) of this section (governing the reconciliation of taxable years).

(iii) *Deficit*—(A) *In general*. The rules of this paragraph (e)(1)(iii) apply when, immediately prior to the foreign section 381 transaction, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in earnings and profits for one or more of the years that comprise its pre-1987 accumulated profits (see also paragraphs (f)(1) and (4) of this section, describing other rules applicable to a deficit described in this paragraph (e)(1)(iii)).

(B) *Aggregate positive pre-1987 accumulated profits*. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in earnings and profits for one or more years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related pre-1987 foreign income taxes of such corporation. A deficit in pre-1987 accumulated profits for one or more years is applied to reduce pre-1987 accumulated profits on a LIFO basis. Any remaining deficit shall be applied to reduce pre-1987 accumulated profits in succeeding years. See Rev. Rul. 74–550 (1974–2 C.B. 209) (see also §601.601(d)(2) of this chapter); *Champion Int'l Corp.* v. *Commissioner*, 81 T.C. 424 (1983), acq. in result, 1987–2 C.B. 1; Rev. Rul. 87–72 (1987–2 C.B. 170) (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(C) *Aggregate deficit in pre-1987 accumulated profits*. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, a hovering deficit as defined under paragraph (d)(2)(i) of this section, then the rules under §1.902–2(b) shall apply to such hovering deficit (and related pre-1987 foreign income taxes) immediately prior to the transaction, except that the aggregate hovering deficit that is carried forward into the foreign surviving corporation's post-1986 pool shall offset only post-transaction earnings accumulated by the foreign surviving corporation in the same separate category of post-1986 undistributed earnings to which the relevant portion of the hovering deficit is attributable. Post-transaction earnings do not include earnings and profits that are earned after the foreign section 381 transaction but distributed or deemed distributed in the same year they are earned.

(D) *Deficit and positive separate categories within annual layers*. For purposes of applying the rules of paragraphs (e)(1)(iii)(B) and (C) of this section, if within a single pre-pooling annual layer, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in pre-1987 accumulated profits in a separate category and positive pre-1987 accumulated profits in another separate category, the deficit shall first be used to offset the positive pre-1987 accumulated profits in the other separate category in the same pre-pooling annual layer. Any remaining deficit shall be carried forward or back to other years according to the rules of paragraph (e)(1)(iii)(B) or (C) of this section as applicable.

(iv) *Pre-1987 section 960 earnings and profits and foreign income taxes*. The pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. The rules otherwise applicable to such amounts shall apply separately to the pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Notice 88–70 (1988–2 C.B. 369) (see also § 601.601(d)(2) of this chapter).

(v) *Examples.* The following examples illustrate the rules of this paragraph (e)(1). The examples assume the following facts: Foreign corporation A was incorporated in 2003 and was a nonpooling corporation through December 31, 2004. Foreign corporation A became a CFC on January 1, 2005 and, as a result, began to maintain a pool of post-1986 undistributed earnings on that date. Foreign corporation B was incorporated in 2003 and has always been owned by foreign shareholders (and thus never has met the requirements of section 902(c)(3)(B)). Both foreign corporation A and foreign corporation B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a ''u'' functional currency. Finally, unless otherwise stated, all earnings and profits of foreign corporations A and B are in the general category. The examples are as follows:

*Example 1.* (i) *Facts.* (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Foreign Corporation A:* | | |
| Post-1986 pool | 1,000u | $350 |
| 2004 | 400u | 160u |
| 2003 | 100u | 5u |
| | 1,500u | |
| *Foreign Corporation B:* | | |
| 2006 | 100u | 20u |
| 2005 | 150u | 30u |
| 2004 | 0u | 50u |
| 2003 | 50u | 5u |
| | 300u | 105u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* Under the rules described in paragraphs (e)(1)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| Post-1986 Pool | 1,000u | $350 |
| 2006 | 100u | 20u |
| 2005 | 150u | 30u |
| *Two Side-by-Side Layers of 2004 E&P:* | | |
| 2004 layer #1 (from Corp A) | 400u | 160u |
| 2004 layer #2 (from Corp B) | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 (from Corp A) | 100u | 5u |
| 2003 layer #2 (from Corp B) | 50u | 5u |
| | 1,800u | .................. |

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,725u to its shareholders. Under the rules of paragraph (c)(1) of this section, the distribution is first out of the post-1986 pool, and then out of the pre-pooling annual layers under the LIFO method, as follows:

| | E&P | Foreign taxes |
|---|---|---|
| Post-1986 pool | 1,000u | $350 |
| 2006 | 100u | 20u |
| 2005 | 150u | 30u |
| *Two Side-by-Side Layers of 2004 E&P:* | | |
| 2004 layer #1 | 400u | 160u |
| 2004 layer #2 | 0u | 0u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 | * 50u | 2.5u |
| 2003 layer #2 | ** 25u | 2.5u |
| | 1,725u | |

* 100u in layer/150u aggregate 2003 earnings = 66.67% × 75u distribution.
** 50u in layer/150u aggregate 2003 earnings = 33.33% × 75u distribution.

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| 2004 layer #2 | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 | 50u | 2.5u |
| 2003 layer #2 | 25u | 2.5u |
| | 75u | 55u |

(iv) *Post-transaction earnings*. For the taxable year ending on December 31, 2008, foreign surviving corporation has 500u of current earnings and profits in the general category, none of which qualify as subpart F income under section 952(a), and pays $70 in foreign income taxes. As of the close of the 2008 taxable year, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| Post-1986 pool | 500u | $70 |
| 2004 | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 | 50u | 2.5u |
| 2003 layer #2 | 25u | 2.5u |
| | 575u | |

*Example 2*. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Foreign Corporation A:* | | |
| Post-1986 pool | 1,000u | $350 |
| 2004 | 100u | 20u |
| 2003 | (50u) | 5u |
| | 1,050u | |
| *Foreign Corporation B:* | | |

| | E&P | Foreign taxes |
|---|---|---|
| 2006 | 100u | 20u |
| 2005 | (50u) | 5u |
| 2004 | 0u | 50u |
| 2003 | 100u | 10u |
| | 150u | 85u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* Because foreign corporations A and B have aggregate positive amounts of pre-1987 accumulated profits with a deficit in one or more years, the rules of paragraph (e)(1)(iii)(B) of this section apply. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Deficit E&P | Foreign taxes available | Foreign taxes assoicated with deficit E&P |
| Post-1986 pool | 1,000u | .................... | $350 | |
| 2006 | 100u | .................... | 20u | |
| 2005 | .................... | (50u) | .................... | 5u |
| Two Side-by-Side Layers of 2004 E&P: | | | | |
| 2004 layer #1 (from Corp A) | 100u | .................... | 20u | |
| 2004 layer #2 (from Corp B) | 0u | .................... | 50u | |
| Two Side-by-Side Layers of 2003 E&P: | | | | |
| 2003 layer #1 (from Corp A) | .................... | (50u) | .................... | 5u |
| 2003 layer #2 (from Corp B) | 100u | .................... | 10u | |
| | 1,300u | (100u) | .................... | 10u |

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,175u to its shareholders. Under the rules described in paragraphs (c)(1) and (e)(1)(iii)(B) of this section, the distribution is first out of the post-1986 pool, and then out of the pre-pooling annual layers, as follows:

| Distribution | E&P | Foreign taxes |
|---|---|---|
| Post-1986 pool | 1,000u | $350 |
| 2006 | 100u | 20u |
| 2005 | 0u | 0u |
| Two Side-by-Side Layers of 2004 E&P: | | |
| 2004 layer #1 | 50u | 20u |
| 2004 layer #2 | 0u | 0u |
| Two Side-by-Side Layers of 2003 E&P: | | |
| 2003 layer #1 | 0u | 0u |
| 2003 layer #2 | 25u | 5u |
| | 1,175u | |

(B) Under paragraph (e)(1)(iii)(B) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more years, apply separately to the pre-1987 accumulated profits and related foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 50u can be distributed from foreign corporation A's pre-pooling annual layers and is out of its 2004 layer #1 (after rolling forward the (50u) deficit in 2003 layer #1 to reduce earnings in 2004 layer #1 to 50u (100u − 50u)). Under the principles of §1.902–1(b)(3), the full 20u of taxes related to 2004 layer #1 is reduced or deemed paid ($20 × (50/50)). 100u is distributed from foreign corporation B's 2006 annual layer. Foreign corporation B's (50u) deficit in 2005 is then rolled back to offset its 2003 annual layer to reduce earnings in that layer to 50u, 25u of which is distributed. Thus, after the distribution, 25u remains in 2003 layer # 2 along with 5u of foreign income taxes (10u × (25u/50u)).

(C) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(D) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| 2005 | 0u | 5u |
| 2004 layer #2 | 0u | 50u |
| Two Side-by-Side Layers of 2003 E&P: | | |
| 2003 layer #1 | 0u | 5u |
| 2003 layer #2 | 25u | 5u |
| | 25u | 65u |

(E) Under paragraph (e)(1)(iii)(B) of this section, the 5u, 50u, and 5u of pre-1987 foreign income taxes related to foreign surviving corporation's 2005 layer, 2004 layer #2, and 2003 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

*Example 3.* (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| Foreign Corporation A: | | |
| Post-1986 pool | 1,000u | $350 |
| 2004 | 150u | 20u |
| 2003 | 100u | 5u |
| | 1,250u | |
| Foreign Corporation B: | | |
| 2006 | 100u | 20u |
| 2005 | (250u) | 5u |
| 2004 | 0u | 50u |
| 2003 | 100u | 10u |
| | (50u) | 85u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* (A) Because foreign corporation B has an aggregate hovering deficit in pre-1987 accumulated profits, the rules of paragraph (e)(1)(iii)(C) of this section apply. Accordingly, §1.902–2(b) applies immediately prior to the foreign section 381 transaction, except that the hovering deficit is carried forward into the foreign surviving corporation's post-1986 undistributed earnings pool and will offset only post-transaction earnings accumulated by foreign surviving corporation in the general category. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes assoicated with hovering deficit |
| Post-1986 pool | 1,000u | (50u) | $350 | $0 |
| 2006 | 0u | | 20u | |
| 2005 | 0u | | 5u | |
| Two Side-by-Side Layers of 2004 E&P: | | | | |
| 2004 layer #1 (from Corp A) | 150u | | 20u | |
| 2004 layer #2 (from Corp B) | 0u | | 50u | |
| Two Side-by-Side Layers of 2003 E&P: | | | | |
| 2003 layer #1 (from Corp A) | 100u | | 5u | |
| 2003 layer #2 (from Corp B) | 0u | | 10u | |
| | 1,250u | (50u) | | $0 |

(B) Under paragraph (e)(1)(iii)(C) of this section, the 20u, 5u, 50u, and 10u of pre-1987 foreign income taxes associated with foreign corporation B's pre-1987 accumulated profits for 2006, 2005, 2004 layer #2, and 2003 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

(2) *If foreign surviving corporation is a nonpooling corporation.* If the foreign surviving corporation is a nonpooling corporation, then the pre-pooling annual layers shall be determined under the rules of this paragraph (e)(2).

(i) *Qualifying earnings and taxes.* The pre-pooling annual layers shall consist of the pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation. If the foreign acquiring corporation or the foreign target corporation (or both) has post-1986 undistributed earnings or a deficit in post-1986 undistributed earnings, then those earnings or deficits and any related post-1986 foreign income taxes shall be recharacterized as pre-1987 accumulated profits or deficits and pre-1987 foreign income taxes of the foreign acquiring corporation or the foreign target corporation accumulated immediately prior to the foreign section 381 transaction.

(ii) *Carryover rule.* Subject to paragraph (e)(2)(iii) of this section, the amounts described in paragraph (e)(2)(i) of this section shall carry over to the foreign surviving corporation but shall not be combined. If the foreign acquiring corporation and the foreign target corporation have pre-1987 accumulated profits in the same year and a distribution is made therefrom, the principles of §1.902–1(b)(2)(ii) and (3) shall apply separately to reduce pre-1987 accumulated profits and pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Rev. Rul. 68–351 (1968–2 C.B. 307); Rev. Rul. 70–373 (1970–2 C.B. 152) (see also §601.601(d)(2) of this chapter); see also paragraph (f)(2) of this section (governing the reconciliation of taxable years).

(iii) *Deficits*—(A) *In general.* The rules of this paragraph (e)(2)(iii) apply when, immediately prior to the foreign section 381 transaction (and after application of the last sentence of paragraph (e)(2)(i) of this section), the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in one or more years that comprise its pre-1987 accumulated profits. See also paragraphs (f)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (e)(2)(iii)).

(B) *Aggregate positive pre-1987 accumulated profits.* If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in pre-1987 accumulated profits in one or more years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related foreign income taxes of such corporation. A deficit in pre-1987 accumulated profits for one or more years is applied to reduce pre-1987 accumulated profits on a LIFO basis. Any remaining deficit shall be applied to reduce pre-1987 accumulated profits in succeeding years. See Rev. Rul. 74–550 (1974–2 C.B. 209) (see also §601.601(d)(2) of this chapter); *Champion Int'l Corp.* v. *Commissioner*, 81 T.C. 424 (1983), acq. in result, 1987–2 C.B. 1; Rev. Rul. 87–72 (1987–2 C.B. 170) (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(C) *Aggregate deficit in pre-1987 accumulated profits.* If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, a hovering deficit as defined under paragraph (d)(2)(i) of this section, then the rules otherwise applicable to such hovering deficits shall apply separately to the pre-transaction earnings and profits and related taxes of the relevant corporation. See, e.g., sections 316(a) and 381(c)(2)(B). Thus, any hovering deficit shall offset only post-transaction earnings accumulated by the foreign surviving corporation in the same separate category of earnings and profits to which the relevant portion of the hovering deficit is attributable. Post-transaction earnings do not include earnings and profits that are earned after the foreign section 381 transaction but distributed or deemed distributed in the same year they are earned. Following the principles of §1.902–2(b), if there is an aggregate deficit in pre-1987 accumulated profits, any related pre-1987 foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and creates a pre-transaction aggregate positive balance for pre-1987 accumulated profits.

(D) *Deficit and positive separate categories within annual layers.* For purposes of applying the rules of paragraphs (e)(2)(iii)(B) and (C) of this section, if within a single pre-pooling annual layer, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in pre-1987 accumulated profits in a separate category and positive pre-1987 accumulated profits in another separate category, the deficit shall first be used to offset the positive pre-1987 accumulated profits in the other separate category in the same pre-pooling annual layer. Any remaining deficit shall be carried forward or back to other years according to the rules of paragraph (e)(2)(iii)(B) or (C) as applicable.

(iv) *Pre-1987 section 960 earnings and profits and foreign income taxes.* The pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. The rules otherwise applicable to such amounts shall apply separately to the pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Notice 88–70 (1988–2 C.B. 369) (see also §601.601(d)(2) of this chapter).

(v) *Examples.* The following examples illustrate the rules of this paragraph (e)(2). The examples assume the following facts: Both foreign corporation A and foreign corporation B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a ''u'' functional currency, and 1u = US$1 at all times. Finally, unless otherwise stated, all earnings and profits of foreign corporations A and B are in the general category. The examples are as follows:

*Example 1.* (i) *Facts.* (A) Foreign corporations A and B both were incorporated in 2003. Nine percent of the voting stock of foreign corporation A is owned by domestic corporate shareholder C. Nine percent of the voting stock of foreign corporation B is owned by domestic corporate shareholder D. Shareholders C and D are unrelated. The remaining 91% of the voting stock of each foreign corporation is owned by unrelated foreign shareholders. Thus, neither corporation meets the requirements of section 902(c)(3)(B). On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Foreign Corporation A:* | | |
| 2006 | 500u | 350u |
| 2005 | 400u | 300u |
| 2004 | 400u | 160u |
| 2003 | 100u | 5u |
| | 1,400u | 815u |
| *Foreign Corporation B:* | | |
| 2006 | 100u | 20u |
| 2005 | 300u | 60u |
| 2004 | 0u | 50u |
| 2003 | 50u | 5u |
| | 450u | 135u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) *Result.* Under the rules described in paragraphs (e)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Two Side-by-Side Layers of 2006 E&P:* | | |
| 2006 layer #1 (from Corp A) | 500u | 350u |
| 2006 layer #2 (from Corp B) | 100u | 20u |
| *Two Side-by-Side Layers of 2005 E&P:* | | |
| 2005 layer #1 (from Corp A) | 400u | 300u |
| 2005 layer #2 (from Corp B) | 300u | 60u |
| *Two Side-by-Side Layers of 2004 E&P:* | | |
| 2004 layer #1 (from Corp A) | 400u | 160u |
| 2004 layer #2 (from Corp B) | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 (from Corp A) | 100u | 5u |
| 2003 layer #2 (from Corp B) | 50u | 5u |
| | 1,850u | 950u |

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 600u to its shareholders. Under the rules of paragraph (c)(3) of this section, the distribution is out of pre-pooling annual layers under the LIFO method as follows:

| | E&P | Foreign taxes |
|---|---|---|
| *Two Side-by-Side Layers of 2006 E&P:* | | |
| 2006 layer #1 (from Corp A) | 500u | 350u |
| 2006 layer #2 (from Corp B) | 100u | 20u |
| | 600u | 370u |

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim deemed paid foreign income taxes under section 902. See § 1.902–1(a)(10)(iii).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Two Side-by-Side Layers of 2005 E&P:* | | |
| 2005 layer #1 (from Corp A) | 400u | 300u |
| 2005 layer #2 (from Corp B) | 300u | 60u |
| *Two Side-by-Side Layers of 2004 E&P:* | | |
| 2004 layer #1 (from Corp A) | 400u | 160u |
| 2004 layer #2 (from Corp B) | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 (from Corp A) | 100u | 5u |
| 2003 layer #2 (from Corp B) | 50u | 5u |
| | 1,250u | 580u |

*Example 2.* (i) *Facts.* (A) The facts are the same as in *Example 1* (i)(A), except that foreign corporation A met the requirements of section 902(c)(3)(B) on January 1, 2005, when U.S. corporate shareholder C acquired an additional 1% of voting stock for a total ownership interest of 10%; foreign corporation A thereby became a pooling corporation. On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Foreign Corporation A:* | | |
| Post-1986 pool | 900u | $650 |
| 2004 | 400u | 160u |
| 2003 | 100u | 5u |
| | 1,400u | .................... |
| *Foreign Corporation B:* | | |
| 2006 | 100u | 20u |
| 2005 | 300u | 60u |
| 2004 | 0u | 50u |
| 2003 | 50u | 5u |
| | 450u | 135u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) *Result.* Under the rules described in paragraphs (e)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Two Side-by-Side Layers of 2006 E&P:* | | |
| 2006 layer #1 (from Corp A's pool) | 900u | $650 |
| 2006 layer #2 (from Corp B's layer) | 100u | 20u |
| 2005 (from Corp B): | 300u | 60u |
| *Two Side-by-Side Layers of 2004 E&P:* | | |
| 2004 layer #1 (from Corp A) | 400u | 160u |
| 2004 layer #2 (from Corp B) | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 (from Corp A) | 100u | 5u |
| 2003 layer #2 (from Corp B) | 50u | 5u |
| | 1,850u | |

(iii) *Subsequent ownership change.* On July 1, 2010, USS (a domestic corporation) acquires 100% of the stock of foreign surviving corporation. Under the rules of paragraph (f)(3) of this section, foreign surviving corporation begins to pool its earnings and profits under section 902(c)(3) as of January 1, 2010. Foreign surviving corporation's earnings and profits and foreign income taxes accrued before January 1, 2010 retain their character as pre-1987 accumulated profits and pre-1987 foreign income taxes.

*Example 3.* (i) *Facts.* (A) The facts are the same as in *Example 2*(i)(A), except that on December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign Taxes |
|---|---|---|
| *Foreign Corporation A:* | | |
| Post-1986 pool | 1,000u | $500 |
| 2004 | (200u) | 10u |
| 2003 | 400u | 5u |
| | 1,200u | |
| *Foreign Corporation B* | | |
| 2006 | 300u | 20u |
| 2005 | (100u) | 60u |
| 2004 | 0u | 50u |
| 2003 | 50u | 5u |
| | 250u | 135u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) *Result.* Because foreign corporations A and B have aggregate positive amounts of pre-1987 accumulated profits with a deficit in one or more years, the rules of paragraph (e)(2)(iii)(B) of this section apply. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Deficit E&P | Foreign taxes available | Foreign taxes associated with deficit E&P |
| *Two Side-by-Side Layers of 2006 E&P:* | | | | |
| 2006 layer #1 (from Corp A's pool) | 1,000u | .................... | $500 | |
| 2006 layer #2 (from Corp B's layer) | 300u | .................... | 20u | |
| 2005 (from Corp B) | .................... | (100u) | .................... | 60u |
| *Two Side-by-Side Layers of 2004 E&P:* | | | | |
| 2004 layer #1 (from Corp A) | .................... | (200u) | .................... | 10u |
| 2004 layer #2 (from Corp B) | 0u | .................... | 50u | |
| *Two Side-by-Side Layers of 2003 E&P:* | | | | |
| 2003 layer #1 (from Corp A) | 400u | .................... | 5u | |
| 2003 layer #2 (from Corp B) | 50u | .................... | 5u | |
| | 1,750u | (300u) | .................... | 70u |

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,300u to its shareholders. Under the rules described in paragraphs (c)(3) and (e)(2)(iii)(B) of this section, the distribution is out of the pre-pooling annual layers, as follows:

| | E&P | Foreign taxes |
|---|---|---|
| *Two Side-by-Side Layers of 2006 E&P:* | | |
| 2006 layer #1 | 1,000u | $500 |
| 2006 layer #2 | 250u | 20u |

| | E&P | Foreign taxes |
|---|---|---|
| *2003 E&P:* | | |
| 2003 layer #1 | 50u<br>1,300u | 1.25u (25% of 5u taxes) |

(B) Under paragraph (e)(2)(iii)(B) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more years, apply separately to the pre-1987 accumulated profits and related pre-1987 foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 1,200u and 250u can be distributed out of foreign corporation A's and foreign corporation B's pre-pooling annual layers, respectively. Thus, 1,000u of the distribution is out of foreign corporation A's 2006 layer #1 and 250u is out of foreign corporation B's 2006 layer #2 (after rolling forward (50u) of the deficit in 2005 layer to reduce earnings in 2006 layer #1 to 250u (300u − 50u)). Under the principles of §1.902–1(b)(3), all of the taxes in each of those respective layers are reduced. The remaining 50u is distributed from foreign corporation A's 2003 layer #1 (after rolling back the (200u) deficit in 2004 layer #1 to reduce earnings in 2003 layer #1 to 200u (400u − 200u)). Thus, after the distribution, 150u remains in the 2003 layer #1 along with 3.75u of foreign income taxes (5u × (150u/200u)).

(C) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim a credit for deemed paid foreign income taxes under section 902. See §1.902–1(a)(10)(iii).

(D) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| 2005 | 0u | 60u |
| *Two Side-by-Side Layers of 2004 E&P:* | | |
| 2004 layer #1 | 0u | 10u |
| 2004 layer #2 | 0u | 50u |
| *Two Side-by-Side Layers of 2003 E&P:* | | |
| 2003 layer #1 | 150u | 3.75u |
| 2003 layer #2 | 0u | 5u |
| | 150u | 128.75u |

(E) Under paragraph (e)(2)(iii)(B) of this section, the 60u, 10u, 50u, and 5u of foreign income taxes related to foreign surviving corporation's 2005 layer, 2004 layer #1, 2004 layer #2, and 2003 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

*Example 4.* (i) *Facts.* (A) The facts are the same as in *Example 2* (i)(A), except that on December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign Taxes |
|---|---|---|
| *Foreign Corporation A:* | | |
| Post-1986 pool | (1,000u) | $20 |
| 2004 | (200u) | 10u |
| 2003 | 400u | 5u |
| | (800u) | |
| *Foreign Corporation B:* | | |
| 2006 | 100u | 20u |
| 2005 | 300u | 60u |
| 2004 | 0u | 50u |
| 2003 | 50u | 5u |

| | E&P | Foreign Taxes |
|---|---|---|
| | 450u | 135u |

(B) On January 1, 2007, foreign corporation A acquires the assets of foreign corporation B in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation.

(ii) *Result.* (A) Under paragraph (e)(2)(i) of this section, foreign corporation A's post-1986 pool is recharacterized as a 2006 layer of pre-1987 accumulated profits. Because after the foreign section 381 transaction foreign corporation A has an aggregate deficit in pre-1987 accumulated profits, the rules of paragraph (e)(2)(iii)(C) of this section apply and the rules otherwise applicable apply separately to the pre-1987 accumulated profits that carry over to foreign surviving corporation from foreign corporation A. The (800u) aggregate deficit in foreign corporation A's pre-1987 accumulated profits is a hovering deficit that will offset only post-transaction earnings accumulated by foreign surviving corporation in the general category. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Deficit E&P | Foreign taxes available | Foreign taxes associated deficit E&P |
| Hovering deficit from Corp A's annual layers | | (800u) | | 0 |
| *Two Side-by-Side Layers of 2006 E&P:* | | | | |
| 2006 layer #1 (from Corp A's pool) | | 0u | | $20 |
| 2006 layer #2 (from Corp B's layer) | 100u | | 20u | |
| 2005 (from Corp B) | 300u | | 60u | |
| *Two Side-by-Side Layers of 2004 E&P:* | | | | |
| 2004 layer #1 (from Corp A) | | 0u | | 10u |
| 2004 layer #2 (from Corp B) | 0u | | 50u | |
| *Two Side-by-Side Layers of 2003 E&P:* | | | | |
| 2003 layer #1 (from Corp A) | 0u | | 5u | |
| 2003 layer #2 (from Corp B) | 50u | | 5u | |
| | 450u | (800u) | 140u | |

(B) Under paragraph (e)(2)(iii)(C) of this section, the $20, 10u, and 5u of pre-1987 foreign income taxes associated with foreign corporation A's pre-1987 accumulated profits for 2006 layer #1, 2004 layer #1, and 2003 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

(iii) *Post-transaction distribution.* (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 200u to its shareholders. Under the rules described in paragraph (e)(2)(iii)(C) of this section, no distribution can be made out of the pre-1987 accumulated profits of foreign corporation A (and the (800u) aggregate hovering deficit will offset only post-transaction earnings accumulated by foreign surviving corporation). Thus, the distribution is out of pre-pooling annual layers as follows:

| | E&P | Foreign taxes paid |
|---|---|---|
| 2006 layer #2 | 100u | 20u |
| 2005 | 100u | 20u |
| | 200u | 40u |

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim deemed paid foreign income taxes under section 902. See §1.902–1(a)(10)(iii).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Deficit E&P | Foreign taxes available | Foreign taxes associated with deficit E&P |
| Hovering deficit from Corp A's annual layers | .................... | (800u) | .................... | 0 |
| *Two Side-by-Side Layers of 2006 E&P:* | | | | |
| 2006 layer #1 (from Corp A's pool) | .................... | 0u | .................... | $20 |
| 2006 layer #2 (from Corp B's layer) | 0u | .................... | 0u | .................... |
| 2005 (from Corp B) | 200u | .................... | 40u | .................... |
| *Two Side-by-Side Layers of 2004 E&P:* | | | | |
| 2004 layer #1 (from Corp A) | .................... | 0u | .................... | 10u |
| 2004 layer #2 (from Corp B) | 0u | .................... | 50u | .................... |
| *Two Side-by-Side Layers of 2003 E&P:* | | | | |
| 2003 layer #1 (from Corp A) | 0u | .................... | 5u | .................... |
| 2003 layer #2 (from Corp B) | 50u | .................... | 5u | .................... |
| | 250u | (800u) | 140u | .................... |

(f) *Special rules*—(1) *Treatment of deficit*—(i) *General rule*. Any deficit described in paragraph (d)(2), (e)(1)(iii), or (e)(2)(iii) of this section shall not be taken into account in determining current or accumulated earnings and profits of a foreign surviving corporation other than to offset post-transaction accumulated earnings, as defined in paragraph (d)(2)(ii) of this section, including for purposes of calculating—

(A) The earnings and profits limitation of section 952(c)(1)(A); and

(B) The amount of the foreign surviving corporation's subpart F income as defined in section 952(a).

(ii) *Exceptions*. The rule in paragraph (i) shall not apply for purposes of calculating an earnings and profits limitation under section 952(c)(1)(B) or (C).

(iii) *Examples*. The following examples illustrate the principles of this paragraph (f)(1). The examples assume the following facts: foreign corporation A, incorporated in 2002, is and always has been a wholly owned subsidiary of USP, a domestic corporation. Foreign corporation B, incorporated in 2004, is and always has been a wholly owned subsidiary of foreign corporation A. Both foreign corporation A and foreign corporation B are organized under the laws of foreign country X and have always had a calendar taxable year. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a ''u'' functional currency. Unless otherwise stated, any earnings and profits or deficit in earnings and profits of foreign corporation A and B in the general category are attributable to subpart F income derived from foreign base company sales income. Foreign corporation C is a wholly owned subsidiary of USP2 and was organized in 2004 under the laws of foreign country Y. Foreign corporation C (and all of its qualified business units as defined in section 989) maintains a ''u'' functional currency. Earnings and profits of foreign corporation C in the general category are not attributable to subpart F income. The examples are as follows:

*Example 1*. (i) *Facts*. (A) On December 31, 2007, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Foreign Corporation A Separate Category:* | | |
| General | (100u) | $25 |
| *Foreign Corporation B Separate Category:* | | |

| | E&P | Foreign taxes |
|---|---|---|
| General | 0u | $10 |

(B) On January 1, 2008, foreign corporation B elects under § 301.7701–3(c) of this chapter to be disregarded as an entity separate from foreign corporation A. Accordingly, foreign corporation B is deemed to have distributed all its property to foreign corporation A in a liquidation described in section 332.

(ii) *Result.* Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | Earnings & profits: | | Foreign taxes: | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 0u | (100u) | $10 | $25 |

(iii) *Post-transaction earnings and subpart F limitations.* (A) In its taxable year ending on December 31, 2008, foreign surviving corporation A earns 300u of subpart F general category income with respect to which it pays $50 in foreign income taxes. The hovering deficit of (100u) meets the requirements under section 952(c)(1)(B) and therefore is taken into account as a qualified deficit that may be used by USP to offset a portion of its income inclusion related to foreign surviving corporation A's subpart F income of 300u in the 2008 taxable year. Accordingly, USP includes 200u in taxable income for the year and is eligible for a deemed paid foreign tax credit under section 960 of $40 (200u subpart F inclusion/300 post-1986 undistributed earnings in the general category = 66.67%, × $60 foreign income taxes in the general category = $40). USP will also include the deemed paid foreign taxes of $40 in taxable income for the year as a deemed dividend pursuant to section 78. The 100u offset under section 952(c)(1)(B) does not result in a reduction of the hovering deficit for purposes of section 316 or section 902.

(B) Foreign surviving corporation A's 100u of subpart F income not included in income by USP will accumulate and be added to its post-1986 undistributed earnings as of the beginning of 2009. This 100u of post-transaction earnings will be offset by the (100u) hovering deficit. Because the amount of earnings offset by the hovering deficit is 100% of the total amount of the hovering deficit, all $25 of the related taxes are added to the post-1986 foreign income taxes pool as well. Accordingly, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2009:

| Separate category | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 0u | (0u) | $45 | $0 |

(C) The 200u included as subpart F income constitutes previously taxed earnings under section 959.

*Example 2.* (i) *Facts.* (A) On July 1, 2007, foreign corporation B elects under § 301.7701–3(c) of this chapter to be disregarded as an entity separate from foreign corporation A. Accordingly, foreign corporation B is deemed to have distributed all of its property to foreign corporation A in a liquidation described in section 332.

(B) Neither foreign corporation A nor B has any post-1986 undistributed earnings or post-1986 foreign income taxes as of the beginning of the 2007 taxable year. For its short taxable year ending on June 30, 2007, foreign corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| Separate category | E&P | Foreign taxes |
| --- | --- | --- |
| General | (200u) | $30 |

(C) For the 2007 taxable year, foreign surviving corporation A earns a total of 200u of subpart F foreign based company sales income in the general category with respect to which it pays $40 in foreign income taxes.

(ii) *Result.* (A) Under paragraph (d)(2) of this section, foreign corporation B's (200u) deficit carries over to foreign surviving corporation A as a hovering deficit. Nevertheless, because it is a deficit of a qualified chain member for a taxable year ending within the 2007 taxable year of foreign surviving corporation A, the (200u) deficit meets the requirements under section 952(c)(1)(C) and therefore may still be taken into account for purposes of limiting foreign surviving corporation A's subpart F income. Accordingly, foreign surviving corporation A's 200u of subpart F income for the 2007 taxable year is fully offset by the (200u) deficit of foreign corporation B, and USP will have no subpart F income inclusion for the 2007 taxable year. The offset under section 952(c)(1)(C) does not result in a reduction of the hovering deficit for purposes of section 316 or section 902. The hovering deficit may not also be taken into account under section 952(c)(1)(B).

(B) Because USP has no subpart F income inclusion, foreign surviving corporation A's subpart F earnings of 200u will accumulate and be added to its post-1986 undistributed earnings as of the beginning of 2008. Under the rules of paragraph (f)(5) of this section, a pro rata amount, in this case 50% or 100u, will be deemed to have been accumulated prior to the foreign section 381 transaction and the other 50%, or 100u, will be deemed to have been accumulated after the foreign section 381 transaction. The 100u of post-transaction earnings will be offset by (100u) of the hovering deficit for purposes of determining the opening balance of the post-1986 undistributed earnings pool in 2008. Because the amount of earnings offset by the hovering deficit is 50% of the total amount of the hovering deficit, $15 (50% of $30) of the related taxes are added to the post-1986 foreign income taxes pool as well. The 100u of pre-transaction earnings remain in the post-1986 undistributed earnings pool. Accordingly, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2008:

| Separate category | Earnings & profits | | Foreign taxes | |
| --- | --- | --- | --- | --- |
| | Positive E&P | Hoverinig deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| General | 100u | (100u) | $55 | $15 |

*Example 3.* (i) *Facts.* (A) On January 1, 2007, foreign corporation B and foreign corporation C have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

| | E&P | Foreign taxes |
| --- | --- | --- |
| *Foreign Corporation B Separate Category:* | | |
| General | (100u) | $0 |
| *Foreign Corporation C Separate Category:* | | |
| General | 0u | $10 |

(B) On July 1, 2007, foreign corporation B acquires the assets of foreign corporation C in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation B is a CFC.

(C) During the 2007 taxable year foreign surviving corporation B has a current deficit of (400u) and $60 of related foreign income taxes. During its short taxable year ending on June 30, 2007, foreign corporation C has no additional earnings and pays or accrues no foreign income taxes.

(ii) *Result.* (A) Under the rules of paragraph (f)(5) of this section, a pro rata amount, in this case 50% or (200u), of foreign surviving corporation B's (400u) current year deficit for the 2007 taxable year will be deemed to have been accumulated prior to the foreign section 381 transaction and be treated as a hovering deficit. The other 50%, or (200u) of the deficit will be deemed to have been accumulated after the foreign section 381 transaction. The related foreign income taxes of $60 will also be allocated on a similar 50/50 basis.

(B) Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes as of January 1, 2008:

| Separate category | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | E&P | Hovering deficit | Foreign taxes available | Foreign taxes assoicated with hovering deficit |
| General | (200u) | (300u) | $40 | $30 |

(iii) *Subpart F income limitations.* Even though (200u) of the current year deficit is treated as a hovering deficit, the full (400u) current year deficit in 2007 of foreign surviving corporation B meets the requirements under section 952(c)(1)(C) and therefore is available as a limitation on subpart F income, to the extent foreign corporation A, which wholly owns foreign surviving corporation B, earns any subpart F income in the 2007 taxable year. Any such offset under section 952(c)(1)(C) will have no effect on the earnings and profits and foreign income tax accounts above of foreign surviving corporation B for purposes of sections 316 and 902. Moreover, to the extent the hovering deficit reduces subpart F income under section 952(c)(1)(C), it may not also be taken into account under section 952(c)(1)(B).

(2) *Reconciling taxable years.* If a foreign acquiring corporation and a foreign target corporation had taxable years ending on different dates, then the pro rata distribution rules of paragraphs (e)(1)(ii) and (e)(2)(ii) of this section shall apply with respect to the taxable years that end within the same calendar year.

(3) *Post-transaction change of status.* If a foreign surviving corporation that is subject to the rules of paragraph (c)(2) of this section subsequently becomes a pooling corporation (by reason, for example, of a reorganization, liquidation, or change of ownership), then post-1986 undistributed earnings and post-1986 foreign income taxes that were recharacterized as pre-1987 accumulated profits and pre-1987 foreign income taxes, respectively, under paragraph (e)(2)(i) of this section retain their characterization as a pre-pooling annual layer.

(4) *Ordering rule for multiple hovering deficits*—(i) *Rule.* A foreign surviving corporation shall apply the deficit rules of paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section in that order if more than one of such rules applies to the foreign surviving corporation.

(ii) *Example.* The following example illustrates the principles of this paragraph (f)(4). The example assumes the following facts: Foreign corporation A has been a pooling corporation since its incorporation on January 1, 1998. Foreign corporation B has been a nonpooling corporation since its incorporation on January 1, 2000. Foreign corporations A and B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a ''u'' functional currency. All earnings and profits of foreign corporation B are in the general category. Finally, unless otherwise stated, any earnings and profits in the passive category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled section 902 corporation and that qualified for the subpart F same-country exception under section 954(c)(3)(A). The example is as follows:

*Example.* (i) *Facts.* (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

| | E&P | Foreign taxes |
|---|---|---|
| *Foreign Corporation A Post-1986 Pool Separate Category:* | | |
| Passive | 400u | $160 |
| General | (300u) | 25 |
| | 100u | 185 |
| Foreign Corporation B: | | |
| 2006 | (300u) | 50u |
| 2005 | 100u | 25u |
| | (200u) | 75u |

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* Under the rules described in paragraphs (d)(1), (d)(2), (e)(1)(i), (e)(1)(ii), and (e)(1)(iii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes availabe | Foreign taxes associated with hovering deficit |
| Post-1986 pool separate category: | | | | |
| Passive | 400u | | $160 | |
| General | | (300u) | | $25 |
| Carryforward pre-pooling deficit from Corp B | | (200u) | | 0 |
| 2006 (from Corp B) | 0u | | 50u | |
| 2005 (from Corp B) | 0u | | 25u | |
| | 400u | (500u) | | $25 |

(iii) *Post-transaction earnings.* (A) In the taxable year ending on December 31, 2007, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

| | E&P | Foreign taxes |
|---|---|---|
| Post-1986 pool separate category: | | |
| Passive | 150u | $40 |
| General | 400u | 60 |
| | 550u | 100 |

(B) None of the earnings and profits qualify as subpart F income as defined in section 952(a). Under paragraph (f)(4)(i) of this section, the rules of paragraph (d)(2) of this section apply before the rules of paragraph (e)(1)(iii) of this section. Accordingly, post-transaction earnings in a separate category are first offset by a hovering deficit in the same separate category in the post-1986 pool. Thus, foreign surviving corporation's (300u) deficit in the general category offsets 300u of post-transaction earnings in the general category. After application of paragraph (d)(2) of this section, the (200u) deficit in the general category carried forward from foreign corporation B's pre-pooling aggregate deficit offsets the remaining 100u of post-transaction earnings in the general category. Accordingly, foreign surviving corporation has the following earnings and profits and foreign income taxes at the end of 2007:

| | Earnings & profits | | Foreign taxes | |
|---|---|---|---|---|
| | Positive E&P | Hovering deficit | Foreign taxes available | Foreign taxes associated with hovering deficit |
| Post-1986 pool separate category: | | | | |
| Passive | 550u | | $200 | |
| General | | | $85 | |
| Carryforward pre-pooling deficit from Corp B | | (100u) | | $0 |
| 2006 (from Corp B) | 0u | | 50u | |
| 2005 (from Corp B) | 0u | | 25u | |
| | 550u | (100u) | | $0 |

(C) Under paragraph (d)(2)(iii) of this section, all of the $25 of post-1986 foreign income taxes related to the (300u) hovering deficit in the general category is added to the foreign surviving corporation's post-1986 foreign income taxes of $60 in that category (because post-transaction earnings in the general category have exceeded the deficit in that category). Under paragraph (e)(1)(iii)(C) of this section, the 50u and 25u of foreign income taxes associated with foreign corporation B's pre-1987 accumulated profits for 2006 and 2005 remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

(5) *Pro rata rule for earnings and deficits during transaction year.* (i) For purposes of offsetting post-transaction earnings of a foreign surviving corporation under the rules described in paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section, the earnings and profits, and any related foreign income taxes, in each separate category for the taxable year of the foreign surviving corporation in which the transaction occurs shall be deemed to have been accumulated after such transaction in an amount which bears the same ratio to the undistributed earnings and profits of the foreign surviving corporation for such taxable year (computed without regard to any earnings and profits carried over) as the number of days in the taxable year after the date of transaction bears to the total number of days in the taxable year. See, e.g., §1.381(c)(2)–1(a)(7) *Example 2* (illustrating application of this rule with respect to domestic corporations).

(ii) For purposes of determining the amount of pre-transaction deficits described in paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section, of a foreign surviving corporation that has a deficit in earnings and profits in any separate category for its taxable year in which the transaction occurs, unless the actual accumulated earnings and profits, or deficit, as of such date can be shown, such pre-transaction deficit, and any related foreign income taxes, shall be deemed to have accumulated in a manner similar to that described in paragraph (f)(5)(i) of this section. See, e.g., §1.381(c)(2)–1(a)(7) *Example 4* (illustrating application of this rule with respect to domestic corporations).

(g) *Effective date.* This section shall apply to section 367(b) transactions that occur on or after November 6, 2006.

[T.D. 9273, 71 FR 44985, Aug. 8, 2006; 71 FR 57889, Oct. 2, 2006, as amended at 71 FR 70876, Dec. 7, 2006]

### § 1.367(b)–8 Allocation of earnings and profits and foreign income taxes in certain foreign corporate separations. [Reserved]

### § 1.367(b)–9 Special rule for F reorganizations and similar transactions.

(a) *Scope.* This section applies to a foreign section 381 transaction (as defined in §1.367(b)–7(a)) either—

(1) That is described in section 368(a)(1)(F); or

(2) That involves—

(i) At least one foreign corporation that holds no property and has no tax attributes immediately before the transaction, other than a nominal amount of assets (and related tax attributes) to facilitate its organization or preserve its existence as a corporation; and