§ 1.367(b)-2 Definitions and special rules.

(a) Controlled foreign corporation. The term "controlled foreign corporation" means a controlled foreign corporation as defined in section 957 (taking into account section 953(c)).

(b) Section 1248 shareholder. The term "section 1248 shareholder" means any United States person that satisfies the ownership requirements of section 1248 (a)(2) or (c)(2) with respect to a foreign corporation.

(c) Section 1248 amount—(1) Rule. The term "section 1248 amount" with respect to stock in a foreign corporation means the net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder. In the case of a transaction in which the shareholder is a foreign corporation (foreign shareholder), the following additional rules shall apply—

(i) The foreign shareholder shall be deemed to be a United States person for purposes of this paragraph (c), except that the foreign shareholder shall not be considered a United States person for purposes of determining whether the stock owned by the foreign shareholder is stock of a controlled foreign corporation; and

(ii) The foreign shareholder's holding period in the stock of the foreign corporation shall be determined by reference to the period that the foreign shareholder's section 1248 shareholders held (directly or indirectly) an interest in the foreign corporation. This paragraph (c)(1)(ii) applies in addition to the section 1248 regulations' incorporation of section 1223 holding periods. See §1.1248-8.

(2) Examples. The following examples illustrate the rules of this paragraph (c):

Example 1. (i) Facts. DC, a domestic corporation, owns all of the outstanding stock of FCI, a controlled foreign corporation (CFC). FCI owns all of the outstanding stock of FC2, a CFC. DC has always owned all of the stock of FCI, and FCI has always owned all of the stock of FC2.

(ii) Result. Under this paragraph (c), DC's section 1248 amount with respect to its FCI stock is computed by reference to all of FCI's and FC2's earnings and profits. See section 1248(c)(2). Because FCI's section 1248 shareholder (DC) always indirectly held all of the stock of FC2, FCI's section 1248 amount with respect to its FC2 stock is computed by reference to all of FC2's earnings and profits.

Example 2. (i) Facts. DC, a domestic corporation, owns 40 percent of the outstanding stock of FCI, a foreign corporation. The other 60 percent of FCI stock is owned (directly and indirectly) by foreign persons that are unrelated to DC. FCI owns all of the outstanding stock of FC2, a foreign corporation. On January 1, 2001, DC purchases the remaining 60 percent of FCI stock.
(ii) Result. Under this paragraph (c), DC’s section 1248 amount with respect to its FC1 stock is computed by reference to FC1’s and FC2’s earnings and profits that accumulated on or after January 1, 2001, the date FC1 and FC2 became controlled foreign corporations (CFCs). See section 1248(a). Because FC1 is not considered a United States person for purposes of determining whether FC2 is a CFC, FC1’s section 1248 amount with respect to its FC2 stock is computed by reference to FC2’s earnings and profits that accumulated on or after January 1, 2001, the date FC2 became an actual CFC.

Example 3. (i) Facts. FC1, a foreign corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC is a domestic corporation that is unrelated to FC1, FC2, and their direct and indirect owners. On January 1, 2001, DC purchases all of the outstanding stock of FC1.

(ii) Result. Under this paragraph (c), DC’s section 1248 amount with respect to its FC1 stock is computed by reference to FC1’s and FC2’s earnings and profits that accumulated on or after January 1, 2001, the date DC held the stock of FC1. See section 1248(a). FC1’s section 1248 amount with respect to its FC2 stock is computed by reference to FC2’s earnings and profits that accumulated on or after January 1, 2001, the date DC’s section 1248 shareholder (DC) indirectly held the stock of FC2.

(d) All earnings and profits amount—(1) General rule. The term all earnings and profits amount with respect to stock in a foreign corporation means the net positive earnings and profits (if any) determined as provided under paragraph (d)(2) of this section and attributable to such stock as provided under paragraph (d)(3) of this section. The all earnings and profits amount shall be determined without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation.

(2) Rules for determining earnings and profits—(i) Domestic rules generally applicable. For purposes of this paragraph (d), except as provided in sections 312(k)(4) and (n)(8), 964 and 986, the earnings and profits of a foreign corporation for any taxable year shall be determined according to principles substantially similar to those applicable to domestic corporations.

(ii) Certain adjustments to earnings and profits. Notwithstanding paragraph (d)(2)(i) of this section, for purposes of this paragraph (d), the earnings and profits of a foreign corporation for any taxable year shall not include the amounts specified in section 1248(d). In the case of amounts specified in section 1248(d)(4), the preceding sentence requires that the earnings and profits for any taxable year be decreased by the net positive amount (if any) of earnings and profits attributable to activities described in section 1248(d)(4), and increased by the net reduction (if any) in earnings and profits attributable to activities described in section 1248(d)(4).

Example 3. (ii) Rule. The all earnings and profits amount with respect to stock of a corporation that distributes all of its property in a liquidation described in section 332 shall be determined without regard to the adjustments prescribed by section 312(a) and (b) resulting from the distribution of such property in liquidation, except that gain or loss realized by the corporation on the distribution shall be taken into account to the extent provided in section 312(f)(1). See §1.367(b)–3(b)(3)(ii) Example 3.

(3) Amount attributable to a block of stock—(i) Application of section 1248 principles—(A) In general—(1) Rule. The all earnings and profits amount with respect to stock of a foreign corporation is determined according to the attribution principles of section 1248 and the regulations thereunder. The attribution principles of section 1248 shall apply without regard to the requirements of section 1248 that are not relevant to the determination of a shareholder’s pro rata portion of earnings and profits. Thus, for example, the all earnings and profits amount is determined without regard to whether the foreign corporation was a controlled foreign corporation at any time during the five years preceding the section 367(b) exchange in question, without regard to whether the shareholder owned a 10 percent or greater interest in the stock, and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years or while the corporation was a controlled foreign corporation.

(2) Example. The following example illustrates the rules of this paragraph (d)(3)(i)(A):
Example. (i) Facts. On January 1, 2001, DC, a domestic corporation, purchases 9 percent of the outstanding stock of FC, a foreign corporation. On January 1, 2002, DC purchases an additional 1 percent of FC stock. On January 1, 2003, DC exchanges its stock in FC in a section 367(b) exchange in which DC is required to include the all earnings and profits amount in income. FC was not a controlled foreign corporation during the entire period DC held its FC stock.

(ii) Result. The all earnings and profits amount with respect to DC’s stock in FC is computed by reference to 9 percent of FC’s earnings and profits from January 1, 2001, through December 31, 2001, and by reference to 1 percent of FC’s earnings and profits from January 1, 2002, through January 1, 2003.

(B) Foreign shareholders. In the case of a transaction in which the exchanging shareholder is a foreign corporation (foreign shareholder), the following additional rules shall apply—

(1) The attribution principles of section 1248 shall apply without regard to whether the person directly owning the stock is a United States person; and

(2) The foreign shareholder’s holding period in the stock of the foreign acquired corporation shall be determined by reference to the period that the foreign shareholder’s United States shareholders (as defined in §1.367(b)-3(b)(2)) held (directly or indirectly) an interest in the foreign acquired corporation. This paragraph (d)(3)(i)(B)(2) applies in addition to the section 1248 regulations incorporated in section 1223 holding periods. See §1.1248-8.

(ii) Exclusion of lower-tier earnings. In applying the attribution principles of section 1248 and the regulations thereunder to determine the all earnings and profits amount with respect to stock of a foreign corporation, the earnings and profits of subsidiaries of the foreign corporation shall not be taken into account notwithstanding section 1248(c)(2).

(e) Treatment of deemed dividends—

(1) In general. In certain circumstances these regulations provide that an exchanging shareholder shall include an amount in income as a deemed dividend. This paragraph provides rules for the treatment of the deemed dividend.

(2) Consequences of dividend characterization. A deemed dividend described in paragraph (e)(1) of this section shall be treated as a dividend for purposes of the Internal Revenue Code. The deemed dividend shall be considered as paid out of the earnings and profits with respect to which the amount of the deemed dividend was determined. Thus, for example, a deemed dividend that is determined by reference to the all earnings and profits amount or the section 1248 amount will never be considered as paid out of (and therefore will never reduce) earnings and profits specified in section 1248(d), because such earnings and profits are excluded in computing the all earnings and profits amount (under paragraph (d)(2)(ii) of this section) and the section 1248 amount (under section 1248(d) and paragraph (c)(1) of this section). If the deemed dividend is determined by reference to the earnings and profits of a foreign corporation that is owned indirectly (i.e., through one or more tiers of intermediate owners) by the person that is required to include the deemed dividend in income, the deemed dividend shall be considered as having been paid by such corporation to such person through the intermediate owners, rather than directly to such person.

(3) Ordering rules. In the case of an exchange of stock in which the exchanging shareholder is treated as receiving a deemed dividend from a foreign corporation, the following ordering rules concerning the timing, treatment, and effect of such a deemed dividend shall apply. See also paragraph (j)(2) of this section.

(i) For purposes of the section 367(b) regulations, the gain realized by an exchanging shareholder shall be determined before increasing (as provided in paragraph (e)(3)(i) of this section) the basis in the stock of the foreign corporation by the amount of the deemed dividend.

(ii) Except as provided in paragraph (e)(3)(i) of this section, the deemed dividend shall be considered to be received immediately before the exchanging shareholder’s receipt of consideration for its stock in the foreign corporation, and the shareholder’s basis in the stock exchanged shall be increased by the amount of the deemed dividend. Such basis increase shall be taken into account before determining the gain otherwise recognized on the exchange (for example, under section 356), the basis
that the exchanging shareholder takes in the property that it receives in the exchange (under section 358(a)(1)), and the basis that the transferee otherwise takes in the transferred stock (under section 362).

(iii) Except as provided in paragraph (e)(3) of this section, the earnings and profits of the appropriate foreign corporation shall be reduced by the deemed dividend amount before determining the consequences of the recognition of gain in excess of the deemed dividend amount (for example, under section 356(a)(2) or sections 356(a)(1) and 1248).

(4) Examples. The following examples illustrate the rules of this paragraph (e):

Example 1. DC, a domestic corporation, exchanges stock in FC, a foreign corporation, in a section 367(b) exchange in which DC includes the all earnings and profits amount in income as a deemed dividend. Under paragraph (e)(2) of this section, a deemed dividend is treated as a dividend for purposes of the Internal Revenue Code. As a result, if the requirements of section 902 are met, DC may qualify for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 2. DC, a domestic corporation, exchanges stock in FC1, a foreign corporation, that is a controlled foreign corporation, in a transaction in which DC is required to include the section 1248 amount in income as a deemed dividend. A portion of the section 1248 amount is determined by reference to the earnings and profits of FC1 (the upper-tier portion of the section 1248 amount), and the remainder of the section 1248 amount is determined by reference to the earnings and profits of FC2, which is a wholly owned foreign subsidiary of FC1 (the lower-tier portion of the section 1248 amount). Under paragraph (e)(2) of this section, DC computes its deemed paid foreign tax credit as if the lower-tier portion of the section 1248 amount were distributed as a dividend by FC2 to FC1, and as if such portion and the upper-tier portion of the section 1248 amount were then distributed as a dividend by FC1 to DC.

Example 3. DC, a domestic corporation, exchanges stock in FC, a foreign corporation, that is a controlled foreign corporation, in a transaction in which DC realizes gain of $100 (prior to the application of the section 367(b) regulations). In connection with the transaction, DC is required to include $40 in income as a deemed dividend under the section 367(b) regulations. In addition to receiving property permitted to be received under section 354 without the recognition of gain, DC also receives cash in the amount of $70. Under paragraph (e)(3) of this section, the $40 deemed dividend increases DC’s basis in its FC stock before determining the gain to be recognized under section 356. Thus, in applying section 356, DC is considered to realize $60 of gain on the exchange, all of which is recognized under section 358(a)(1).

(f) Deemed asset transfer and closing of taxable year in certain section 368(a)(1)(F) reorganizations—(1) Scope. This paragraph applies to a reorganization described in section 368(a)(1)(F) in which the transferor corporation is a foreign corporation.

(2) Deemed asset transfer. In a reorganization described in paragraph (f)(1) of this section, there is considered to exist—

(i) A transfer of assets by the foreign transferor corporation to the acquiring corporation in exchange for stock (or stock and securities) of the acquiring corporation and the assumption by the acquiring corporation of the foreign transferor corporation’s liabilities;

(ii) A transfer of stock (or stock and securities) by the foreign transferor corporation to its shareholders (or shareholders and security holders); and

(iii) An exchange by the foreign transferor corporation’s shareholders (or shareholders and security holders) of their stock (or stock and securities) for stock (or stock and securities) of the acquiring corporation.

(3) Other applicable rules. For purposes of this paragraph (f), it is immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuation of the foreign transferor corporation.

(4) Closing of taxable year. In a reorganization described in paragraph (f)(1) of this section, the taxable year of the foreign transferor corporation shall end with the close of the date of the transfer and, except as otherwise required under the Internal Revenue Code (e.g. section 1502 and the regulations thereunder), the taxable year of the acquiring corporation shall end with the close of the date on which the transferor’s taxable year would have ended but for the occurrence of the reorganization if—

(i) The acquiring corporation is a domestic corporation; or

(ii) The foreign transferor corporation has effectively connected earnings
and profits (as defined in section 884(d)) or accumulated effectively connected earnings and profits (as defined in section 884(b)(2)(B)(ii)).

(g) Stapled stock under section 269B. For rules addressing the deemed conversion of a foreign corporation to a domestic corporation under section 269B, see §1.269B–1(c).

(h) Section 953(d) domestication elections.—(1) Effect of election. A foreign corporation that elects under section 953(d) to be treated as a domestic corporation shall be treated for purposes of section 367(b) as transferring, as of the first day of the first taxable year for which the election is effective, all of its assets to a domestic corporation in a reorganization described in section 988(a)(1)(F). Notwithstanding paragraph (d) of this section, for purposes of determining the consequences of the reorganization under §1.367(b)–3, the all earnings and profits amount shall not be considered to include earnings and profits accumulated in taxable years beginning before January 1, 1988.

(2) Post-election exchanges. For purposes of applying section 367(b) to post-election exchanges with respect to a corporation that has made a valid election under section 953(d) to be treated as a domestic corporation, such corporation shall be treated as a domestic corporation as to earnings and profits that were taken into account at the time of the section 953(d) election or which accrue after such election, and shall be treated as a foreign corporation as to earnings and profits accumulated in taxable years beginning before January 1, 1988. Thus, for example, if the section 953(d) corporation subsequently transfers its assets to a domestic corporation (other than another section 953(d) corporation) in a transaction described in section 381(a), the rules of §1.367(b)–3 shall apply to such transaction to the extent of the section 953(d) corporation’s earnings and profits accumulated in taxable years beginning before January 1, 1988.

(i) Section 1504(d) elections. An election under section 1504(d), which permits certain foreign corporations to be treated as domestic corporations, is treated as a transfer of property to a domestic corporation and will generally constitute a reorganization described in section 368(a)(1)(F). However, if an election under section 1504(d) is made with respect to a foreign corporation from the first day of the foreign corporation’s existence, then the foreign corporation shall be treated as a domestic corporation, and the section 367(b) regulations will not apply.

(j) Sections 985 through 989—(1) Change in functional currency of a qualified business unit.—(i) Rule. If, as a result of a section 367(b) exchange described in section 381(a), a qualified business unit (as defined in section 988(a)(1)(F)) has a different functional currency determined under the rules of section 985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction. A QBU that is deemed to change its functional currency pursuant to this paragraph (j) must make the adjustments described in §1.985–5.

(ii) Example. The following example illustrates the rule of this paragraph (j)(1):

Example. (i) Facts. DC, a domestic corporation, owns 100 percent of FC1, a foreign corporation. FC1 owns and operates a qualified business unit (QBU) (B1) in France, whose functional currency is the euro. FC2, an unrelated foreign corporation, owns and operates a QBU (B2) in France, whose functional currency is the dollar. FC2 acquires FC1’s assets (including B1) in a reorganization described in section 368(a)(1)(C). As a part of the reorganization, B1 and B2 combine their operations into one QBU. Applying the rules of section 985(b), the functional currency of the combined operations of B1 and B2 is the euro.

(ii) Result. FC2’s acquisition of FC1’s assets is a section 367(b) exchange that is described in section 381(a). Because the functional currency of the combined operations of B1 and B2 after the exchange is the euro, B2 is deemed to have automatically changed its functional currency to the euro immediately prior to the section 367(b) exchange. B2 must make the adjustments described in §1.985–5.

(2) Previously taxed earnings and profits.—(1) Exchanging shareholder that is a United States person. If an exchanging shareholder that is a United States person is required to include in income either the all earnings and profits amount or the section 1248 amount under the provisions of §1.367(b)–3 or 1.367(b)–4, then immediately prior to
the exchange, and solely for the purpose of computing exchange gain or loss under section 986(c), the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a United States person is a distributee in an exchange described in §1.367(b)–5(c) or (d), then immediately prior to the exchange, and solely for the purpose of computing exchange gain or loss under section 986(c), the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a foreign corporation, including for purposes of computing gain or loss realized with respect to the stock on the transaction. The exchanging shareholder’s dollar basis with respect to each account of previously taxed income shall be increased or decreased by the exchange gain or loss recognized.

(ii) Exchanging shareholder that is a foreign corporation. If an exchanging shareholder that is a foreign corporation is required to include in income either the all earnings and profits amount or the section 1248 amount under the provisions of §1.367(b)–3 or §1.367(b)–4, then, immediately prior to the exchange, the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a foreign corporation is a distributee in an exchange described in §1.367(b)–5(c) or (d), then the exchanging shareholder shall be treated as receiving (immediately prior to the exchange) a distribution of previously taxed earnings and profits from the appropriate foreign corporation. Such distribution shall be measured by the extent to which the exchanging shareholder’s direct or indirect United States shareholders (as defined in section 951(b)) have a diminished interest in such previously taxed earnings and profits after the exchange.

(3) Other rules. See sections 985 through 989 for other currency rules that may apply in connection with a section 367(b) exchange.

(k) Partnerships, trusts and estates. In applying the section 367(b) regulations, stock of a corporation that is owned by a foreign partnership, trust or estate shall be considered as owned proportionately by its partners, owners, or beneficiaries under the principles of §1.367(e)–1(b)(2). Stock owned by an entity that is disregarded as an entity separate from its owner under §301.7701–3 is owned directly by the owner of such entity. In applying §1.367(b)–5(b), the principles of §1.367(e)–1(b)(2) shall also apply to a domestic partnership, trust or estate.

(1) Additional definitions—(i) Foreign income taxes. The term foreign income taxes has the meaning set forth in §1.902–1(a)(7).

(ii) Pre-1986 undistributed earnings. The term pre-1986 undistributed earnings has the meaning set forth in §1.902–1(a)(9).

(iii) Pre-1986 foreign income taxes. The term pre-1986 foreign income taxes has the meaning set forth in §1.902–1(a)(8).

(iv) Pre-1987 accumulated profits. The term pre-1987 accumulated profits means the earnings and profits described in §1.902–1(a)(10)(i), computed in accordance with the rules of §1.902–1(a)(10)(ii).

(v) Pre-1987 foreign income taxes. The term pre-1987 foreign income taxes has the meaning set forth in §1.902–1(a)(10)(iii).

(vi) Pre-1987 section 960 earnings and profits. The term pre-1987 section 960 earnings and profits means the earnings and profits of a foreign corporation accumulated in taxable years beginning before January 1, 1987, computed under §1.964–1(a) through (e), and translated into the functional currency (as determined under section 985) of the foreign corporation at the spot rate on the first day of the foreign corporation’s first taxable year beginning after December 31, 1986. For further guidance, see Notice 88–70 (1988–2 C.B. 369, 370)
The term pre-1987 section 960 earnings and profits does not include earnings and profits that represent previously taxed earnings and profits described in section 959.

(7) Pre-1987 section 960 foreign income taxes. The term pre-1987 section 960 foreign income taxes means the foreign income taxes related to pre-1987 section 960 earnings and profits, determined in accordance with the principles of §1.902–1(a)(10)(iii), except that the U.S. dollar amounts of pre-1987 section 960 foreign income taxes are determined by reference to the exchange rates in effect when the taxes were paid or accrued.

(8) Earnings and profits. For purposes of §§1.367(b)–7 and 1.367(b)–9, the term earnings and profits means post-1986 undistributed earnings, pre-1987 accumulated profits, and pre-1987 section 960 earnings and profits.

(9) Pooling corporation. The term pooling corporation means a foreign corporation with respect to which the requirements of section 902(c)(3)(B) have been met in the current taxable year or any prior taxable year.

(10) Nonpooling corporation. The term nonpooling corporation means a foreign corporation that is not a pooling corporation.

(11) Separate category. The term separate category has the meaning set forth in section 904(d)(1), and shall also include any other category of income to which section 904(a), (b), and (c) are applied separately under any other provision of the Internal Revenue Code (e.g., sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(i), and 904(h)(1)(A) of taxable years beginning on or before December 31, 2006).

(12) Passive category. The term passive category means the separate category that includes income described in section 904(d)(1)(A).

(13) General category. The term general category means the separate category that includes income described in section 904(d)(1)(B) (or section 904(d)(1)(I) for taxable years beginning on or before December 31, 2006).

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