in a loss of control described in paragraph (c)(3) of this section. Accordingly, under paragraph (c)(1) of this section, the FS stock owned by B is included in the denominator, but not in the numerator, of the ownership fraction. Therefore, the ownership fraction is 40/100. FS is not a surrogate foreign corporation.

Example 8. Internal group restructuring; partnership. (1) Facts. LLC, a Delaware limited liability company, is engaged in the conduct of a trade or business. P, a corporation, holds 90 percent of the interests of LLC. A, a person unrelated to P, holds 10 percent of the interests of LLC. LLC has not elected to be treated as an association taxable as a corporation. P and A transfer their interests in LLC to FS, a newly formed foreign corporation, in exchange for 90 shares and 10 shares, respectively, of FS’s stock, which are all of the outstanding shares of FS. Accordingly, LLC becomes a disregarded entity.

(ii) Analysis. Prior to the FS’s acquisition of the interests of LLC, LLC was a domestic partnership for Federal income tax purposes. FS has acquired substantially all the properties constituting a trade or business of LLC pursuant to a plan. After the acquisition, P holds 90 percent of FS’s stock (by vote and value) by reason of holding a capital and profits interest in LLC, and A holds 10 percent of FS’s stock (by vote and value) by reason of holding a capital and profits interest in LLC. The internal group restructuring exception under paragraph (c)(2) of this section applies, because before the acquisition, P held 80 percent or more of the capital and profits interest in LLC, and A holds 10 percent of the stock (by vote and value) of FS. Under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator, of the ownership fraction. Accordingly, the ownership fraction is 10/100. FS is not a surrogate foreign corporation.

(g) Effective/applicability date. Except as otherwise provided in this paragraph, this section shall apply to acquisitions completed on or after May 20, 2008. This section shall not, however, apply to an acquisition that was completed on or after May 20, 2008, provided such acquisition was entered into pursuant to a written agreement which was (subject to customary conditions) binding prior to May 20, 2008, and at all times thereafter (binding commitment). For purposes of the preceding sentence, a binding commitment shall include entering into options and similar interests in connection with one or more written agreements described in the preceding sentence. Notwithstanding the general application of this paragraph, taxpayers may elect to apply this section to prior acquisitions, but must apply it consistently to all acquisitions within its scope. Paragraph (e) of this section shall apply to acquisitions completed on or after June 7, 2012. See §1.7874-1T(e), as contained in 26 CFR part 1 revised as of April 1, 2012, for acquisitions completed before June 7, 2012.

Paragraph (k) of this section provides examples that illustrate the rules of this section. Paragraph (l) of this section provides the effective/applicability date of this section.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(3) Downstream transactions. An acqui-
sition by a corporation of its stock
from another corporation or a partner-
nship (for example, as a result of a
downstream merger) is an acquisition
of the other corporation’s or partner-
ship’s properties for purposes of section
7874(a)(2)(B)(i).

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

e) Acquisitions of multiple domestic en-
tities. If, pursuant to a plan (or a series
of related transactions), a foreign cor-
noration completes two or more acqui-
sitions described in section
7874(a)(2)(B)(i) involving domestic cor-
norations and/or domestic partnerships
(domestic entities), then, for purposes
of section 7874(a)(2)(B)(ii), the acqui-
sitions shall be treated as a single acqui-
sition and the domestic entities shall
be treated as a single domestic entity.

The transaction involves one or more
domestic corporations and one or more
domestic partnerships, the stock of the
foreign corporation held by former
shareholders and former partners by
reason of holding stock or a partner-
ship interest in the domestic entities
shall be aggregated for purposes of de-
termining whether the ownership con-
dition of section 7874(a)(2)(B)(ii) is sat-
isfied. See Example 7 of paragraph (k) of
this section for an illustration of the
rules of this paragraph (e).

(f) Stock held by reason of holding stock
in a domestic corporation or an interest in
a domestic partnership—(1) Specified
transactions. For purposes of section
7874(a)(2)(B)(ii), stock of a foreign cor-
noration that is held by reason of hold-
ing stock in a domestic corporation (or
an interest in a domestic partnership)
includes, but is not limited to, the
stock described in paragraphs (f)(1)(i)
through (iii) of this section.

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

(ii) Stock of a foreign corporation re-
cieved in exchange for, or with respect
to, an interest in a domestic partner-
ship.

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

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

(ii) Interest in a domestic partnership.
If, pursuant to the same transaction,
stock of a foreign corporation is re-
cieved in exchange for, or with respect
to, an interest in a domestic partner-
ship and other property, the stock of
the foreign corporation that was re-
cieved in exchange for, or with respect
to, the interest in the domestic part-
nership shall be determined based on the
relative value of the interest in the

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domestic partnership compared to the aggregate value of such interest and the other property.

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

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

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

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

(ii) At any time after the acquisition pursuant to a plan that existed at the time of the acquisition. For this purpose, a plan shall be deemed to exist at the time of the acquisition if the foreign partnership would, but for section 7704(c), be treated as a corporation under section 7704(a) immediately preceding the first date properties are acquired as part of the acquisition.

(3) Surrogate foreign corporation to which section 7874(b) applies. If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, the publicly traded foreign corporation shall be treated as a surrogate foreign corporation to which section 7874(b) does not apply, the publicly traded foreign corporation shall continue to be treated as a surrogate foreign corporation for purposes of the Code, but section 7874(a)(1) shall apply to any expatriated entity (as defined in section 7874(a)(2)(A)). See Example 13 of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(3).

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

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

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

(h) Options—(1) Value. Except to the extent otherwise provided in this paragraph (h), for purposes of section 7874, including for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1), an option with respect to a corporation or partnership will be treated as stock in the corporation, or an interest in the partnership, as applicable, with a value equal to the holder’s claim on the equity of the corporation or partnership. For this purpose, claim on the equity equals the value of the stock or partnership interest that may be acquired pursuant to the option, less the exercise price (but in no case is a claim on the equity less than zero). Also for this purpose, the equity of the corporation or partnership shall not include the amount of any property the holder of the option would be required to provide to the corporation or partnership under the terms of the option if such option were exercised. See Example 14 and Example 16 of paragraph (k) of this section for illustrations of the rules of this paragraph (h)(1).

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

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

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

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

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

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

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

(5) Options and interests similar to an option. For purposes of this paragraph (h), an option includes an interest similar to an option. Examples of options (including interests similar to options) include, but are not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock or a partnership interest, a contract to acquire or sell stock or a partnership interest, and an exchangeable share or exchangeable partnership interest.

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

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

(ii) Interests providing substantially similar material respects to the distribution rights provided by stock in the foreign corporation. For this purpose, distribution rights include rights to dividends (or partnership distributions), distributions in redemption of the interest (in whole or in part), and any other rights to distributions (or partnership distributions) from the foreign corporation.
part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder’s investment in the interest.

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

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

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

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

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

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

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

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

(i) DC1 and DC2 are domestic corporations.

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

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

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

(v) Under the terms of the partnership agreements of DPS and FPS, each
Example 1. Acquisition of stock of a domestic corporation. (i) Facts. FA wholly owns DC1. FP wholly owns FA. FP acquires 25% of the properties held by DC1. (ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring 25% of the properties held by DC1 on the date of the stock acquisition.

Example 2. Acquisition of a partnership interest. (i) Facts. DC1 and DC2 shall be treated as a single domestic corporation. DC1 wholly owns F1. F1 acquires 40% of the properties held by DC1.

(ii) Analysis. Under paragraph (c)(1)(ii) of this section, for purposes of section 7874(a)(2)(B)(i), F1 is treated as acquiring 40% of the properties held by DC1 on the date of the acquisition of the partnership interest.

Example 3. Acquisition of stock by a subsidiary. (i) Facts. FP wholly owns FA. FA acquires all the outstanding stock of DC1 in exchange for FP stock. FP wholly owns DC1. (ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring all the properties held by DC1 on the date of the stock acquisition. Further, under paragraph (c)(1)(ii) of this section, for purposes of section 7874(a)(2)(B)(i), FP is also treated as acquiring 100% of the properties held by DC1 on the date of the stock acquisition. The result would be the same if instead FA had directly acquired all the properties held by DC1 in exchange for FP stock.
stock of such domestic corporation, and the ownership fraction under section 7874(a)(2)(B)(ii) is 100/100, or 100%.

Example 8. Exchange of stock and other property

Factor A and B exchange for Federal tax purposes as of the date of the formation of HPS, HPS is a foreign eligible entity under §301.7701–2, and DC1 and B make an election under §301.7701–3 to treat HPS as a partnership for Federal tax purposes as of the date of the formation of HPS. HPS forms DC2. One day after the formation of HPS, DC2 merges with and into DC1. Pursuant to the merger agreement, the DC1 shareholders exchange their DC1 stock solely for membership interests in HPS. After the merger HPS wholly owns DC1, and the former shareholders of DC1 own a greater than 80% interest in HPS by reason of holding stock of DC1.

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

Example 12. Publicly traded foreign partnership not treated as a surrogate foreign corporation

Public trading of the HPS ownership interests begins the day after the date on which the merger is completed. HPS is not treated as a corporation under section 7704(a) by reason of section 7704(c). If HPS were a corporation, the condition of section 7874(a)(2)(B)(ii) would be satisfied.

(ii) Analysis. HPS is a publicly traded foreign partnership that is described in paragraph (g)(2) of this section. Therefore, under paragraph (g)(1) of this section, for purposes of section 7874, HPS is treated as a foreign corporation organized under the law of Country A and the membership interests in HPS are treated as stock of the foreign corporation. The foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, pursuant to the merger, HPS acquired substantially all of the properties held by DC1, the former shareholders of DC1 hold at least 60% of the stock of the foreign corporation by reason of holding stock of DC1, and the expanded affiliated group includes the foreign corporation does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Further, because the former shareholders of DC1 hold at least 80% of the stock of the foreign corporation by reason of holding stock of DC1, section 7874(b) applies to the surrogate foreign corporation, and therefore HPS is treated as a domestic corporation for purposes of the Code. Under paragraph (g)(6) of this section, except for purposes of determining whether HPS is a surrogate foreign corporation, at the end of the day immediately preceding the date of the merger of DC2 with and into DC1, HPS is treated as transferring all of its assets and liabilities to a new domestic corporation in exchange solely for stock of the domestic corporation. HPS is then treated as proportionately distributing such stock to its membership interest holders in liquidation of the partnership. In addition, as a result of the merger of DC2 with and into DC1, the former shareholders of DC1 shall be treated as receiving stock of a domestic corporation in exchange for their DC1 stock.
membership interests in HPS are treated as stock of the foreign corporation. However, the foreign corporation is not treated as a surrogate foreign corporation under section 7874.(a)(2)(B) because, after the acquisition, the expanded affiliated group that includes HPS has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Therefore, under paragraph (g)(5) of this section, section 7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under section 7874.(a) by reason of the acquisition.

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

(ii) Analysis. Under paragraph (g)(1) of this section, for purposes of section 7874, FPS is treated as a foreign corporation because the conditions of section 7874.(a)(2)(B) are satisfied. However, because the former shareholders of DC1 hold less than an 80%-interest in FPS by reason of holding DC1 stock, the expanded affiliated group (treated as a surrogate foreign corporation for this purpose) does not have substantial business activities in Country A and is not treated as a surrogate foreign corporation under section 7874.

Example 14. Warrant to acquire stock from the foreign parent corporation. (i) Facts. Individual A and B equally own DC1. DC1 has a $200x value. Individual A transfers all of its DC1 stock to FA in exchange solely for the option to acquire DC1 stock (treated as DC1 stock) for an exercise price of $20x. At the time of the acquisition, the FA stock that individual C can acquire under the option has a $70x value.

(ii) Analysis. Under paragraphs (h)(1) of this section, for purposes of section 7874, individual C is treated as owning FA stock with a $200x value. Therefore, under paragraph (g)(5) of this section, section 7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under section 7874.(a) by reason of the acquisition. Therefore, under paragraph (g)(5) of this section, section 7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under section 7874.(a) by reason of the acquisition.

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

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

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

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

Example 17. Stock in a subsidiary treated as stock of a foreign parent corporation. (i) Facts. (A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. FA contributes part of the cash from the public offering to DC2, a newly formed corporation, in exchange for all the stock of DC2. DC2 merges with and into DC1 with DC1 surviving. Pursuant to the merger agreement, individuals
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A and B exchange their DC1 stock for cash and shares of class B stock of DC1. Following the merger FA owns all the class A stock of DC1. FA does not hold significant assets other than the class A stock; the value of the class B stock held by individuals A and B is approximately equal to any dividend distributions made by FA with respect to its publicly traded stock. In certain circumstances, the class B stock also permits individuals A and B to require DC1 to redeem the stock at fair market value. The class B stock does not provide individuals A and B voting rights with respect to FA.

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

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

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

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

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

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

Example 20. Conversion to a domestic corporation and application of section 367. (i) Facts. Individuals A and B are United States persons and equally own DC1. Pursuant to a plan, individuals A and B transfer their DC1 stock to FA in exchange solely for 80% of the outstanding FA stock. After the acquisition, the expanded affiliated group that includes FA does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.
(ii) Analysis. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring all of the properties held by DC1 on the date of the stock acquisition. After the acquisition, the former shareholders of DC1 own 80% of the stock of FA by reason of holding DC1 stock. Therefore, FA is a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b). Under paragraph (j)(1) of this section, except for purposes of determining whether FA is treated as a surrogate foreign corporation, the conversion of FA to a domestic corporation constitutes a reorganization described in section 368(a)(1)(F) that occurs at the end of the day immediately preceding the date of the stock acquisition. Section 367 applies to the conversion of FA to a domestic corporation. See, for example, §§1.367(b)-2 and 1.367(b)-3 for the consequences of the conversion. Under paragraph (j)(3) of this section, section 367 does not apply to the transfers of DC1 stock by individuals A and B to FA.

(l) Effective/applicability date. This section applies to acquisitions completed on or after June 7, 2012. For acquisitions completed prior to June 7, 2012, see §1.7874–2T(o), as contained in 26 CFR part 1, revised as of April 1, 2012.

[T.D. 9591, 77 FR 34791, June 12, 2012]

§ 1.7874–3T Substantial business activities (temporary).

(a) Scope. This section provides rules regarding whether a foreign corporation has substantial business activities in the relevant foreign country when compared to the total business activities of the expanded affiliated group for purposes of section 7874(a)(2)(B)(iii). Paragraph (b) of this section sets forth the threshold of business activities that constitute substantial business activities. Paragraph (c) of this section describes certain items not to be taken into account in the numerator, but are taken into account in the denominator, for each of the tests described in paragraphs (b)(1) through (b)(3) of this section:

(1) Any group assets, group employees, or group income attributable to business activities that are associated with properties or liabilities the transfer of which is disregarded under section 7874(c)(4).

(2) Any group assets or group employees located in, or group income derived in, the relevant foreign country as part of a plan with a principal purpose of avoiding the purposes of section 7874.

(3) Any group assets or group employees located in, or group income derived in, the relevant foreign country if such group assets or group employees, or the business activities to which such