treated as not outstanding for purposes of determining whether P and S are members of a parent-subsidiary controlled group of corporations within the meaning of paragraph (a)(2) of §1.1563–1. Thus, P is considered to own stock possessing 100 percent (70÷70) of the total voting power and value of all the S stock. Accordingly, P and S are members of a parent-subsidiary controlled group of corporations.

Example (2). Assume the same facts as in example (1) and further assume that Jones owns 15 shares of the 100 shares of the only class of stock of corporation S–1, and corporation S owns 75 shares of such stock. P satisfies the 50 percent stock ownership requirement of subparagraph (1) of this paragraph with respect to S–1 since P is considered as owning 52.5 percent (70 percent× 75 percent) of the S–1 stock with the application of paragraph (b)(4) of §1.1563–3. Since Jones is an officer of P, under subparagraph (2)(ii) of this paragraph, the S–1 stock owned by Jones is treated as not outstanding for purposes of determining whether S–1 is a member of the parent-subsidiary controlled group of corporations. Thus, S is considered to own stock possessing 88.2 percent (75÷85) of the voting power and value of the S–1 stock. Accordingly, P, S, and S–1 are members of a parent-subsidiary controlled group of corporations.

Example (3). Corporation X owns 60 percent of the only class of stock of corporation Y. Davis, the president of Y, owns the remaining 40 percent of the stock of Y. Davis has agreed that if he offers his stock in Y for sale he will first offer the stock to X at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since Davis is an employee of Y within the meaning of section 3306(i) of the Code, and his stock in Y is subject to a condition which substantially restricts or limits his right to dispose of such stock and runs in favor of X, under subparagraph (2)(iii) of this paragraph such stock is treated as if it were not outstanding for purposes of determining whether X and Y are members of a parent-subsidiary controlled group of corporations. Thus, X is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, X and Y are members of a parent-subsidiary controlled group of corporations. The result would be the same if Davis's wife, instead of Davis, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of X.

(c) *Exception*—(1) *General.* If stock of a corporation is owned by a person directly or with the application of the rules contained in paragraph (b) of §1.1563–3 and such ownership results in the corporation being a component member of a controlled group of corporations on a December 31, then the stock shall not be treated as excluded stock under the provisions of paragraph (b) of this section if the result of applying such provisions is that such corporation is not a component member of a controlled group of corporations on such December 31.

(2) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

Example. On each day of 1965, corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. Jones, an officer of P, owns directly 30 shares of S stock and P has an option to acquire such 30 shares from Jones. The remaining shares of S are owned by unrelated persons. If, pursuant to the provisions of paragraph (b)(2)(ii) of this section, the 30 shares of S stock owned directly by Jones is treated as not outstanding, the result is that P would be treated as owning stock possessing only 71 percent (50÷70) of the total voting power and value of S stock, and S would not be a component member of a controlled group of corporations on December 31, 1965. However, since P is considered as owning the 30 shares of S stock with the application of paragraph (b)(1) of this section, and such ownership plus the S stock directly owned by P (50 shares) results in S being a component member of a controlled group of corporations on December 31, 1965, the provisions of this paragraph apply. Therefore, the provisions of paragraph (b)(2)(ii) of this section do not apply with respect to the 30 shares of S stock, and on December 31, 1965, S is a component member of a controlled group of corporations consisting of P and S.

[T.D. 6845, 30 FR 9753, Aug. 5, 1965, as amended by T.D. 7181, 37 FR 8070, Apr. 4, 1972]

§1.1563–3 Rules for determining stock ownership.

(a) *In general.* In determining stock ownership for purposes of §§1.1562–5, 1.1563–1, 1.1563–2, and this section, the constructive ownership rules of paragraph (b) of this section apply to the extent such rules are referred to in such sections. The application of such rules shall be subject to the operating rules and special rules contained in paragraphs (c) and (d) of this section.

(b) *Constructive ownership*—(1) *Options.* If a person has an option to acquire any outstanding stock of a corporation, such stock shall be considered as owned by such person. For purposes of this subparagraph, an option

to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock. For example, assume Smith owns an option to purchase 100 shares of the outstanding stock of M Corporation. Under this subparagraph, Smith is considered to own such 100 shares. The result would be the same if Smith owned an option to acquire the option (or one of a series of options) to purchase 100 shares of M stock.

(2) *Attribution from partnerships.* (i) Stock owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever such proportion is the greater.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Green, Jones, and White, unrelated individuals, are partners in the GJW partnership. The partners' interests in the capital and profits of the partnership are as follows:

Partner	Capital	Profits
	Percent	Percent
Green	36	25
Jones	60	71
White	4	4

The GJW partnership owns the entire outstanding stock (100 shares) of X Corporation. Under this subparagraph, Green is considered to own the X stock owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is the greater. Therefore, Green is considered to own 36 shares of the X stock. However, since Jones has a greater interest in the profits of the partnership, he is considered to own the X stock in proportion to his interest in such profits. Therefore, Jones is considered to own 71 shares of the X stock. Since White does not have an interest of 5 percent or more in either the capital or profits of the partnership, he is not considered to own any shares of the X stock.

(3) *Attribution from estates or trusts.* (i) Stock owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5 percent or more in such stock, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary. A beneficiary of an estate or trust who cannot under any circumstances receive any interest in stock held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such stock. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate is bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly, a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in §20.2031–7 of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in stock owned directly or indirectly by or for a trust.

(ii) For the purposes of this subparagraph, property of a decedent shall be considered as owned by his estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death. With respect to an estate, the term ''beneficiary'' includes any person entitled to receive property of the decedent pursuant to a will or pursuant to laws of descent and distribution. A

person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When pursuant to the preceding sentence, a person ceases to be a beneficiary, stock owned by the estate shall not thereafter be considered owned by him.

(iii) Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under Subpart E, Part I, Subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(iv) This subparagraph does not apply to stock owned by any employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(4) *Attribution from corporations.* (i) Stock owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (within the meaning of section 1563(d)) 5 percent or more in value or its stock in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Brown, an individual, owns 60 shares of the 100 shares of the only class of outstanding stock of corporation P. Smith, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, Brown is considered to own 30 shares of the S stock ($^{60}/_{100}\times 50$), and X is considered to own 18 shares of the S stock ($^{36}/_{100}\times 50$). Since Smith does not own 5 percent or more in value of the P stock, he is not considered as owning any of the S stock owned by P. If, in this example, Smith's wife had owned directly 1 share of the P stock, Smith (and his wife) would each own 5 shares of the P stock, and therefore Smith (and his wife) would be considered as owning 2.5 shares of the S stock ($^{5}/_{100}\times 50$).

(5) *Spouse.* (i) Except as provided in subdivision (ii) of this subparagraph, an individual shall be considered to own the stock owned, directly or indirectly, by or for his spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) An individual shall not be considered to own stock in a corporation owned, directly or indirectly, by or for his spouse on any day of a taxable year of such corporation, provided that each of the following conditions are satisfied with respect to such taxable year:

(a) Such individual does not, at any time during such taxable year, own directly any stock in such corporation.

(b) Such individual is not a member of the board of directors or an employee of such corporation and does not participate in the management of such corporation at any time during such taxable year.

(c) Not more than 50 percent of such corporation's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities.

(d) Such stock in such corporation is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock and which run in favor of the individual or his children who have not attained the age of 21 years. The principles of paragraph (b)(2)(iii) of §1.1563–2 shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) For purposes of subdivision (ii)(*c*) of this subparagraph, the gross income of a corporation for a taxable year shall be determined under section 61 and the regulations thereunder. The terms ''royalties'', ''rents'', ''dividends'', ''interest'', and ''annuities'' shall have the same meanings such terms are given for purposes of section 1244(c). See paragraph (e)(1)(ii), (iii), (iv), (v), and (vi) of §1.1244(c)–1.

(6) *Children, grandchildren, parents, and grandparents.* (i) An individual shall be considered to own the stock owned, directly or indirectly, by or for

his children who have not attained the age of 21 years, and, if the individual has not attained the age of 21 years, the stock owned, directly or indirectly, by or for his parents.

(ii) If an individual owns (directly, and with the application of the rules of this paragraph but without regard to this subdivision) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock in a corporation, then such individual shall be considered to own the stock in such corporation owned, directly or indirectly, by or for his parents, grandparents, grandchildren, and children who have attained the age of 21 years. In determining whether the stock owned by an individual possesses the requisite percentage of the total combined voting power of all classes of stock entitled to vote of a corporation, see paragraph (a)(6) of §1.1563–1.

(iii) For purposes of section 1563, and §§1.1563–1 through 1.1563–4, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(iv) The provisions of this subparagraph may be illustrated by the following example:

Example (a) Facts. Individual F owns directly 40 shares of the 100 shares of the only class of stock of Z Corporation. His son, M (20 years of age), owns directly 30 shares of such stock, and his son, A (30 years of age), owns directly 20 shares of such stock. The remaining 10 shares of the Z stock are owned by an unrelated person.

(b) F's ownership. Individual F owns 40 shares of the Z stock directly and is considered to own the 30 shares of Z stock owned directly by M. Since, for purposes of the more-than-50-percent stock ownership test contained in subdivision (ii) of this subparagraph, F is treated as owning 70 shares or 70 percent of the total voting power and value of the Z stock, he is also considered as owning the 20 shares owned by his adult son, A. Accordingly, F is considered as owning a total of 90 shares of the Z stock.

(c) M's ownership. Minor son, M, owns 30 shares of the Z stock directly, and is considered to own the 40 shares of Z stock owned directly by his father, F. However, M is not considered to own the 20 shares of Z stock owned directly by his brother, A, and constructively by F, because stock constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such stock. See paragraph (c)(2) of this section. Accordingly, M owns and is considered as owning a total of 70 shares of the Z stock.

(d) A's ownership. Adult son, A, owns 20 shares of the Z stock directly. Since, for purposes of the more-than-50-percent stock ownership test contained in subdivision (ii) of this subparagraph, A is treated as owning only the Z stock which he owns directly, he does not satisfy the condition precedent for the attribution of Z stock from his father. Accordingly, A is treated as owning only the 20 shares of Z stock which he owns directly.

(c) *Operating rules and special rules*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, stock constructively owned by a person by reason of the application of subparagraph (1), (2), (3), (4), (5), or (6) of paragraph (b) of this section shall, for purposes of applying such subparagraphs, be treated as actually owned by such person.

(2) *Members of family.* Stock constructively owned by an individual by reason of the application of subparagraph (5) or (6) of paragraph (b) of this section shall not be treated as owned by him for purposes of again applying such subparagraphs in order to make another the constructive owner of such stock.

(3) *Precedence of option attribution.* For purposes of this section, if stock may be considered as owned by a person under subparagraph (1) of paragraph (b) of this section (relating to option attribution) and under any other subparagraph of such paragraph, such stock shall be considered as owned by such person under subparagraph (1) of such paragraph.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, 30 years of age, has a 90 percent interest in the capital and profits of a partnership. The partnership owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under subparagraph (1) of this paragraph, the 60 shares of Y constructively owned by the partnership by reason of subparagraph (4) of paragraph (b) of this section is treated as actually owned by the partnership for purposes of applying subparagraph (2) of paragraph (b) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under subparagraph (2) of this paragraph such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts assumed for purposes of example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in subparagraph (2) of this paragraph does not prevent the reattribution of such 40 shares to A because, under subparagraph (3) of this paragraph, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A satisfies the more-than-50-percent stock ownership test contained in paragraph (b)(6)(ii) of this section with respect to Y, the 40 shares of Y stock constructively owned by C are reattributed to A, and A is considered as owning a total of 94 shares of Y stock.

(d) *Special rule of section 1563 (f)(3)(B)*—(1) *In general.* If the same stock of a corporation is owned (within the meaning of section 1563(d)) by two or more persons, then such stock shall be treated as owned by the person whose ownership of such stock results in the corporation being a component member of a controlled group on a December 31 which has at least one other component member on such date.

(2) *Component member of more than one group.* (i) If, by reason of subparagraph (1) of this paragraph, a corporation would (but for this subparagraph) become a component member of more than one controlled group on a December 31, such corporation shall be treated as a component member of only one such controlled group on such date. The determination as to which group such corporation is treated as a component member of shall be made in accordance with the rules contained in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) In any case in which a corporation is a component member of a controlled group of corporations on a December 31 as a result of treating each share of its stock as owned only by the person who owns such share directly, then each such share shall be treated as owned by the person who owns such share directly.

(iii) If the application of subdivision (ii) of this subparagraph does not result in a corporation being treated as a component member of only one controlled group on a December 31, then the stock of such corporation described in subparagraph (1) of this paragraph shall be treated as owned by the one person described in such subparagraph who owns, directly and with the application of the rules contained in paragraph (b) (1), (2), (3), and (4) of this section, the stock possessing the greatest percentage of the total value of shares of all classes of stock of the corporation.

(iv) If the application of subdivision (ii) or (iii) of this subparagraph does not result in a corporation being treated as a component member of only one controlled group of corporations on a December 31, then the determination of that group of which such corporation is to be treated as a component member shall be made by the district director with audit jurisdiction of such corporation's return for the taxable year that includes such December 31 unless such corporation files an election as provided in this subdivision. The election shall be in the form of a statement, signed by a person authorized to act on behalf of such corporation, designating the group in which the corporation has elected to be included. The statement shall provide all the information with respect to stock ownership which is reasonably necessary to satisfy the district director that the corporation would, but for the election, be a component member of more than one controlled group. The statement shall be filed on or before the due date (including extensions of time) for the filing of the income tax return of such corporation for the taxable year. However, in the case of an election with respect to December 31, 1970, the statement shall be considered as timely filed if filed on or before December 15, 1971. Once filed, the election is irrevocable and effective until subdivision (ii) or (iii) of this subparagraph applies or until there is a substantial change in the stock ownership of such corporation.

(3) *Examples.* The provisions of this paragraph may be illustrated by the

following examples, in which each corporation referred to uses the calendar year as its taxable year and the stated facts are assumed to exist on each day of 1970 (unless otherwise provided in the example):

Example (1). Jones owns all the stock of corporation X and has an option to purchase from Smith all the outstanding stock of corporation Y. Smith owns all the outstanding stock of corporation Z. Since the Y stock is considered as owned by two or more persons, under subparagraph (2)(ii) of this paragraph the Y stock is treated as owned only by Smith since he has direct ownership of such stock. Therefore, on December 31, 1970, Y and Z are component members of the same brother-sister controlled group. If, however, Smith had owned his stock in corporation Z for less than one-half of the number of days of Z's 1970 taxable year, then under subparagraph (1) of this paragraph the Y stock would be treated as owned only by Jones since his ownership results in Y being a component member of a controlled group on December 31, 1970.

Example (2). Individual H owns directly all the outstanding stock of corporation M. W (the wife of H) owns directly all the outstanding stock of corporation N. Neither spouse is considered as owning the stock directly owned by the other because each of the conditions prescribed in paragraph (b)(5)(ii) of this section is satisfied with respect to each corporation's 1970 taxable year. H owns directly 60 percent of the only class of stock of corporation P and W owns the remaining 40 percent of the P stock. Under subparagraph (2)(iii) of this paragraph, the stock of P is treated as owned only by H since H owns (directly and with the application of the rules contained in paragraph (b)(1), (2), (3), and (4) of this section) the stock possessing the greatest percentage of the total value of shares of all classes of stock of P. Accordingly, on December 31, 1970, P is treated as a component member of a brother-sister group consisting of M and P.

Example (3). Unrelated individuals A and B each own 49 percent of all the outstanding stock of corporation R, which in turn owns 70 percent of the only class of outstanding stock of corporation S. The remaining 30 percent of the stock of corporation S is owned by unrelated individual C. C also owns the remaining 2 percent of the stock of corporation R. Under the attribution rule of paragraph (b)(4) of this section A and B are each considered to own 34.3 percent of the stock of corporation S. Accordingly, since five or fewer persons own at least 80 percent of the stock of corporations R and S and also own more than 50 percent identically (A's and B's identical ownership each is 34.3 percent, C's identical ownership is 2 percent), on December 31, 1970, corporations R and S are treated as component members of the same brother-sister controlled group.

[T.D. 6845, 30 FR 9755, Aug. 5, 1965, as amended by T.D. 7181, 37 FR 8070, Apr. 25, 1972; T.D. 7779, 46 FR 29474, June 2, 1981; T.D. 8179, 53 FR 6613, Mar. 2, 1988]

§ 1.1563–4 Franchised corporations.

(a) *In general.* For purposes of paragraph (b)(2)(ii)*(d)* of § 1.1563–1, a member of a controlled group of corporations shall be considered to be a franchised corporation for a taxable year if each of the following conditions is satisfied for one-half (or more) of the number of days preceding the December 31 included within such taxable year (or, if such taxable year does not include a December 31, for one-half or more of the number of days in such taxable year preceding the last day of such year):

(1) Such member is franchised to sell the products of another member, or the common owner, of such controlled group.

(2) More than 50 percent (determined on the basis of cost) of all the goods held by such member primarily for sale to its customers are acquired from members or the common owner of the controlled group, or both.

(3) The stock of such member is to be sold to an employee (or employees) of such member pursuant to a bona fide plan designed to eliminate the stock ownership of the parent corporation (as defined in paragraph (b)(1) of § 1.1563–2) or of the common owner (as defined in paragraph (b)(3) of § 1.1563–2) in such member.

(4) Such employee owns (or such employees in the aggregate own) directly more than 20 percent of the total value of shares of all classes of stock of such member. For purposes of this subparagraph, the determination of whether an employee (or employees) owns the requisite percentage of the total value of the stock of the member shall be made without regard to paragraph (b) of § 1.1563–2, relating to certain stock treated as excluded stock. Furthermore, if the corporation has more than one class of stock outstanding, the relative voting rights as between each such class of stock shall be disregarded in making such determination.