

Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

(n) *Effective date*—(1) *General rule.* This section applies to any split-dollar life insurance arrangement entered into after September 17, 2003. For purposes of this section, an arrangement is entered into as determined under § 1.61-22(j)(1)(ii).

(2) *Modified arrangements treated as new arrangements.* If an arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of § 1.61-22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

[T.D. 9092, 68 FR 54352, Sept. 17, 2003]

§ 1.7874-1T Disregard of affiliate-owned stock (temporary).

(a) *Scope.* Section 7874(c)(2)(A) provides that stock of the foreign corporation referred to in section 7874(a)(2)(B) held by members of the expanded affiliated group that includes such foreign corporation (the EAG) shall not be taken into account in determining, for purposes of section 7874(a)(2)(B)(ii), the percentage of stock in such foreign corporation held, after the acquisition, by former shareholders or partners of the domestic corporation or partnership referred to in section 7874(a)(2)(B)(i) (the domestic entity) by reason of having held stock or a partnership interest in the domestic entity. This section provides rules under section 7874(c)(2)(A).

(b) *General rule.* Except as provided in paragraph (c) of this section, for purposes of the ownership percentage determination required by section 7874(a)(2)(B)(ii), stock held by one or more members of the EAG is not included in either the numerator or the denominator of the fraction that determines such percentage. For purposes of this § 1.7874-1T, stock held by a partnership shall be considered as held proportionately by its partners.

(c) *Special rules.* For purposes of the ownership percentage determination required by section 7874(a)(2)(B)(ii), stock held by one or more members of the EAG shall be included in the denominator, but not in the numerator, of the fraction that determines the percentage if:

(1)(i) Before the acquisition, 80 percent or more of the stock (by vote or value) or the capital or profits interest in the domestic entity was owned directly or indirectly by the corporation that is the common parent of the EAG after the acquisition; and

(ii) After the acquisition, stock held by non-members of the EAG by reason of holding stock or a capital or profits interest in the domestic entity, if any, does not exceed 20 percent of the stock (by vote or value) of the foreign corporation; or

(2) After the acquisition, the former shareholders or partners of the domestic entity do not own, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.

(d) *Disregard of subsidiary-owned interests.* Stock or partnership interests owned by an entity in which at least 50 percent of the stock (by vote or value), or at least 50 percent of the capital or profits interest, is owned directly or indirectly by the issuer of such stock or by the partnership in question shall not be taken into account for purposes of:

(1) Determining the percentage of ownership of an entity under paragraphs (c)(1) and (c)(2) of this section; or

(2) Treating stock held by one or more members of the EAG as included in the denominator but not in the numerator under paragraph (c) of this section.

(e) *Examples.* The application of this section is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003. In all the examples, *the EAG* means the expanded affiliated group which includes the foreign corporation that has completed the direct or indirect acquisition referred to in section 7874(a)(2)(B)(i). In all the examples, if an entity or other person is not described as either domestic or foreign,

it may be either domestic or foreign. The analysis of the following examples is limited to a discussion of issues under section 7874, even though the examples may raise other issues (for example, under section 367):

Example 1. Disregard of hook stock. (i) *Facts.* A is a domestic corporation with 100 shares of a single class of common stock outstanding. A's stock is held by a group of individuals. Pursuant to a plan, A forms F, a foreign corporation, and transfers to F the stock of several wholly owned foreign subsidiaries, in exchange for 90 shares of F stock. F then forms Merger Sub, a domestic corporation. Under a merger agreement and state law, Merger Sub merges into A, with A surviving the merger as a subsidiary of F. In exchange for their A stock, the former shareholders of A receive, in the aggregate, 100 shares of F stock. A continues to hold 90 shares of F stock.

(ii) *Analysis.* F has indirectly acquired substantially all the properties of A pursuant to a plan. After the acquisition, the former shareholders of A own 100 shares of F stock by reason of holding stock in A, and A owns 90 shares of F stock. Under paragraph (b) of this section, the 90 shares of F stock held by A, a member of the EAG, are not included in either the numerator or the denominator of the fraction that determines the percentage of F stock owned by former shareholders of A by reason of holding stock in A. Accordingly, the fraction is 100/100 and the percentage is 100%. If the condition stated in section 7874(a)(2)(B)(iii) regarding relatively insubstantial business activities in F's country of incorporation is satisfied, F is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

Example 2. Intra-group restructuring; wholly owned corporation. (i) *Facts.* USS, a domestic corporation, has 100 shares of common stock outstanding, all of which are owned by P, a corporation. As part of an internal restructuring within the P group, USS transfers all its assets to FS, a newly formed foreign corporation, in exchange for stock of FS, in a reorganization described in section 368(a)(1)(F). P exchanges its USS stock for FS stock under section 354.

(ii) *Analysis.* FS has acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. P, the common parent of the EAG, held more than 80% of the stock of USS before the acquisition. After the acquisition, less than 20% of FS's stock is owned by non-members of the EAG. Under paragraph (c)(1) of this section, the FS stock owned by P by reason of holding stock in USS is included in the denominator but not in the numerator of the fraction that determines the percentage of FS stock owned by former shareholders of USS by reason of

holding stock in USS. Accordingly, the fraction is 0/100 and the percentage is 0%. FS is not a surrogate foreign corporation.

Example 3. Intra-group restructuring; wholly owned corporation. (i) *Facts.* The facts are the same as in *Example 2* except that USS does not transfer any of its assets. P transfers all 100 shares of USS stock to FS in exchange for FS stock.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. P, the common parent of the EAG, held more than 80% of the stock of USS before the acquisition. After the acquisition, less than 20% of FS's stock is owned by non-members of the EAG. Under paragraph (c)(1) of this section, the FS stock owned by P by reason of holding stock in USS is included in the denominator but not in the numerator of the fraction that determines the percentage of stock owned by former shareholders of USS by reason of holding stock in USS. Accordingly, the fraction is 0/100 and the percentage is 0%. FS is not a surrogate foreign corporation.

Example 4. Intra-group restructuring; less than wholly owned corporation. (i) *Facts.* The facts are the same as in *Example 2* except that P owns 85 shares of USS stock. The remaining 15 shares of USS stock are owned by A, a person unrelated to P. As part of an internal restructuring within the P group, P and A transfer all their USS stock to FS, in exchange for an equal number of shares of FS stock.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. After the acquisition, P owns 85 shares of FS stock by reason of holding stock in USS, and A owns 15 shares of FS stock by reason of holding stock in USS. Before the acquisition, USS was more than 80% owned by P, which is the common parent of the EAG, and after the acquisition, less than 20% of FS's stock is owned by non-members of the EAG (i.e., by A) by reason of holding stock in USS. Under paragraph (c)(1) of this section, the FS stock owned by P is included in the denominator, but is not included in the numerator, of the fraction that determines the percentage of FS stock owned by former shareholders of USS by reason of holding stock in USS. Accordingly, the fraction is 15/100 and the percentage is 15%. FS is not a surrogate foreign corporation. FS is a controlled foreign corporation.

Example 5. Formation of joint venture corporation. (i) *Facts.* M, a corporation, owns all the outstanding stock of S, a domestic corporation engaged in business Y in the United States. B, a corporation unrelated to M, owns several foreign subsidiaries that are engaged in business Y outside the United States. M and B enter into an agreement under which each will transfer certain assets

to FJV, a newly formed foreign corporation, in exchange for stock of FJV. FJV will conduct business Y on a worldwide basis. Pursuant to the plan, M transfers to FJV all the outstanding stock of S in exchange for 40 shares of FJV stock, and B transfers to FJV the stock of several foreign corporations in exchange for 60 shares of FJV stock. FJV has no other stock outstanding.

(ii) *Analysis.* FJV has indirectly acquired substantially all the properties held directly or indirectly by S pursuant to a plan. After the acquisition, M owns 40 shares of FJV stock by reason of holding stock in S, and B owns the remaining 60 shares of FJV stock. M does not own, directly or indirectly, more than 50% of the stock of any member of the EAG. Under paragraph (c)(2) of this section, the FJV stock owned by B is included in the denominator but not the numerator of the fraction that determines the percentage of FJV stock owned by former shareholders of S by reason of holding stock in S. Accordingly, the fraction is 40/100 and the percentage is 40%. FJV is not a surrogate foreign corporation.

Example 6. Acquisition of existing joint venture entity. (i) *Facts.* K and L are unrelated corporations. T is a domestic corporation with 100 shares of stock outstanding, 55 of which are held by K and 45 of which are held by L. K and L contribute their T stock to U, a newly formed foreign corporation, in exchange for an equal number of shares of U stock.

(ii) *Analysis.* U has indirectly acquired substantially all the properties held directly or indirectly by T pursuant to a plan. After the acquisition, K owns 55 shares of U stock by reason of holding stock in T, and L owns 45 shares of U stock by reason of holding stock in T. Under paragraph (b) of this section, the U stock held by K is not included in either the numerator or the denominator of the fraction that determines the percentage of U stock owned by former shareholders of T by reason of holding stock in T. Accordingly, the fraction is 45/45 and the percentage is 100%. If the EAG does not have substantial business activities in U's country of incorporation when compared to the total business activities of the EAG, U is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

Example 7. Intra-group restructuring; less than wholly owned partnership. (i) *Facts.* LLC, a Delaware limited liability company engaged in the conduct of a trade or business, is 90% owned by C, a corporation, and 10% owned by D, a person unrelated to C. LLC has not elected to be treated as an association taxable as a corporation. As part of an internal restructuring within the C group, C and D transfer their interests in LLC to E, a newly formed foreign corporation, in exchange for 90 shares and 10 shares, respec-

tively, of E's common stock, which are all of the issued and outstanding shares of E.

(ii) *Analysis.* LLC is a domestic partnership for Federal income tax purposes. E has indirectly acquired substantially all the properties constituting a trade or business of LLC pursuant to a plan. After the acquisition, C holds 90% of E's stock by reason of holding a capital or profits interest in LLC, and D holds 10% of E's stock by reason of holding a capital or profits interest in LLC. Before the acquisition, LLC is more than 80% owned by C, the common parent of the EAG, and after the acquisition, less than 20% of E's stock is owned by non-members of the EAG (that is by D) by reason of holding a capital or profits interest in LLC. Under paragraph (c)(1) of this section, the E stock held by C is included in the denominator but not the numerator of the fraction that determines the percentage of E stock owned by former partners of LLC by reason of holding an interest in LLC. Accordingly, the fraction is 10/100 and the percentage is 10%. E is not a surrogate foreign corporation.

Example 8. Acquisition of 50-50 joint venture partnership. (i) *Facts.* The facts are the same as in *Example 7* except that C and D each own 50% of the capital and profits interests in LLC. C and D transfer their interests in LLC to G, a newly formed foreign corporation, in exchange for 50 shares each of G's common stock, which are all of the issued and outstanding shares of G.

(ii) *Analysis.* G has indirectly acquired substantially all the properties constituting a trade or business of LLC, a domestic partnership, pursuant to a plan. After the acquisition, C and D each hold 50% of G's stock by reason of holding an interest in LLC. G is not included in an expanded affiliated group after the acquisition. Accordingly, none of the stock of G is disregarded under this section in determining the percentage of G stock held by former partners of LLC by reason of holding an interest in LLC. Thus, the fraction is 100/100 and the percentage is 100%. If the EAG does not have substantial business activities in G's country of incorporation when compared to the total business activities of the EAG, G is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

(e) *Effective date.* This section applies to taxable years ending after March 4, 2003.

[T.D. 9238, 70 FR 76687, Dec. 28, 2005]

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

(a) *Scope.* This section provides rules under section 7874(a)(2)(B) for determining whether a foreign corporation shall be treated as a surrogate foreign

corporation. Paragraph (b) of this section provides rules under section 7874(a)(2)(B)(i) regarding the indirect acquisition of properties held directly or indirectly by a domestic corporation or domestic partnership. Paragraph (c) of this section provides rules under section 7874(a)(2)(B)(ii) for identifying stock of the entity held by former shareholders or partners of the domestic entity by reason of holding stock or a partnership interest in the domestic entity. Paragraph (d) of this section provides rules under section 7874(a)(2)(B)(iii) for determining whether the expanded affiliated group (as defined in section 7874(c)(1)) that includes the entity (EAG) has substantial business activities in the foreign country in which, or under the laws of which, the entity was created or organized, when compared to the total business activities of the EAG. Paragraph (e) of this section provides rules under which a publicly traded foreign partnership is treated as a foreign corporation for purposes of determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B), and rules regarding the consequences under the Code if a partnership is treated as a surrogate foreign corporation. Paragraph (f) of this section provides rules under which certain interests held by former shareholders or partners of the domestic entity are treated as stock of the foreign entity making the acquisition described in section 7874(a)(2)(B)(i). Paragraph (g) of this section provides rules relating to the change in status from a foreign corporation to a domestic corporation under section 7874(b). Paragraph (h) of this section provides that section 367 is not applicable to the transfer of assets or stock to a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b).

(b) *Indirect acquisition of properties—*
 (1) *Acquisition of stock of a domestic corporation.* For purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of stock of a domestic corporation is considered an indirect acquisition by such foreign corporation of a proportionate amount of the properties held directly or indirectly by such domestic corporation.

(2) *Acquisition of stock of a foreign corporation.* For purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of stock of a second foreign corporation is not considered an indirect acquisition by the first foreign corporation of any properties held directly or indirectly by a domestic corporation or domestic partnership owned directly or indirectly, wholly or partly, by the second foreign corporation.

(3) *Acquisition of an interest in a partnership.* For purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of a capital or profits interest in a foreign or domestic partnership that holds stock in a domestic corporation is considered an indirect acquisition by such foreign corporation of a proportionate amount of the properties held directly or indirectly by such domestic corporation.

(4) *Acquisition of stock or assets of a domestic corporation by controlled subsidiary.* For purposes of section 7874(a)(2)(B)(i) and paragraph (b)(1) of this section, if a corporation acquires stock or assets of a domestic corporation in exchange for stock of a foreign corporation which owns directly or indirectly, after the acquisition, more than 50 percent of the stock (by vote or value) of the acquiring corporation, such foreign corporation is considered as acquiring a proportionate amount of such stock or assets of the domestic corporation.

(5) *Examples.* The application of this paragraph is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003. The examples read as follows:

Example 1. Acquisition of stock of domestic corporation. A is a domestic corporation with 100 shares of a single class of common stock outstanding. F, a foreign corporation, acquires 25 shares of A stock from a shareholder of A. For purposes of section 7874(a)(2)(B)(i), F is considered to have made an indirect acquisition of 25% of the properties held directly or indirectly by A.

Example 2. Acquisition of stock of foreign corporation. The facts are the same as in Example 1 except as follows: All of A's stock is held by B, a foreign corporation. C, a foreign corporation, acquires 25 shares of B stock from a shareholder of B. For purposes of section 7874(a)(2)(B)(i), C is not considered to have made an indirect acquisition of any

portion of the properties held directly or indirectly by A.

Example 3. Acquisition of partnership interest. D is a partnership which owns all of the issued and outstanding stock of E, a domestic corporation. G, a foreign corporation, acquires a 40% interest in D from a partner in D. For purposes of section 7874(a)(2)(B)(i), G is considered to have made an indirect acquisition of 40% of the properties held directly or indirectly by E.

Example 4. Acquisition by controlled corporation. FS, a foreign corporation, is 90% owned by foreign corporation FP. Pursuant to a plan of reorganization, FS acquires all the stock of DT, a domestic corporation, in exchange for stock of FP which is exchanged with the shareholders of DT on a one-for-one basis. For purposes of section 7874(a)(2)(B)(i) and paragraph (b)(1) of this section, FP is considered to have acquired 90% of the stock of DT and thus to have made an indirect acquisition of 90% of the properties held directly or indirectly by DT. If FS had acquired substantially all the assets of DT, rather than the stock of DT, in exchange for stock of FP, FP would be considered to have acquired 90% of the assets of DT for purposes of section 7874(a)(2)(B)(i).

(c) *Stock held by former shareholders or partners by reason of holding stock or a partnership interest in the domestic entity—(1) General rule.* For purposes of section 7874(a)(2)(B)(ii), stock of the foreign corporation which is received by a former shareholder of the domestic corporation in exchange for stock of the domestic corporation is considered stock held by reason of holding stock in the domestic corporation. Similarly, for purposes of section 7874(a)(2)(B)(ii), stock of the foreign corporation which is received by a former partner of the domestic partnership in exchange for a capital or profits interest in the domestic partnership is considered stock held by reason of holding a capital or profits interest in the domestic partnership. Subject to section 7874(c)(4), in cases where the foreign corporation also issues stock to a former shareholder of the domestic corporation or partner of the domestic partnership in the same transaction or series of transactions in exchange for consideration other than stock in the domestic corporation or a capital or profits interest in the domestic partnership, the percentage of the foreign corporation's stock considered to be held by former shareholders of the domestic corporation or former partners of the domestic partnership

by reason of holding stock in the domestic corporation or a capital or profits interest in the domestic partnership shall be determined on the basis of the relative value of the property in exchange for which the foreign corporation's stock was issued.

(2) *Former shareholders and former partners.* For purposes of this section, former shareholders of the domestic corporation are persons who held stock in the domestic corporation before the acquisition, including persons (if any) who held stock in the domestic corporation both before and after the acquisition. Former partners of the domestic partnership are persons who held a capital or profits interest in the domestic partnership before the acquisition, including persons (if any) who held a capital or profits interest in the domestic partnership both before and after the acquisition.

(3) *Example.* The following example illustrates the application of this paragraph:

Example. Contribution of stock of domestic and foreign corporations. A holds all of the issued and outstanding common stock of DC, FC1, FC2, and FC3. DC is a domestic corporation, and FC1, FC2, and FC3 are foreign corporations. Each of DC, FC1, FC2, and FC3 has only one class of stock outstanding. DC's outstanding stock is worth \$40x, FC1's outstanding stock is worth \$20x, FC2's outstanding stock is worth \$25x, and FC3's outstanding stock is worth \$15x. In a transaction subject to section 351, A contributes the stock of DC, FC1, FC2, and FC3 to FP, a foreign corporation, in exchange for all of the issued and outstanding common stock of FP. The transaction occurs after March 4, 2003. For purposes of section 7874(a)(2)(B)(ii), A is considered to hold 40% of the stock of FP by reason of holding stock in DC.

(d) *Substantial business activities of the EAG—(1) General rule—(i) Facts and circumstances test.* Subject to paragraph (d)(2) of this section, the determination of whether, after the acquisition, the EAG has substantial business activities in the foreign country in which, or under the law of which, the acquiring foreign entity is created or organized, when compared to the total business activities of the EAG, shall be made on the basis of all of the facts and circumstances. However, the factors described in paragraph (d)(1)(iii) of this section shall not be taken into account

in making the determination. For the EAG to have substantial business activities in the foreign country when compared to the total business activities of the EAG, there is no minimum percentage of its total business activities (regardless of how measured) that must be in the foreign country. It is necessary, however, for the determination of substantiality to be made on the basis of a comparison to the total business activities of the EAG, and the factors set forth in paragraph (d)(1)(ii) of this section are to be evaluated accordingly. Thus, it is possible that the business activities of an EAG in a particular country would be substantial when compared to the total business activities of such EAG, but the identical business activities of another EAG in the same country would not be substantial when compared to the total business activities of that EAG because the total business activities of the second EAG were much more extensive than the total business activities of the first EAG.

(ii) *Factors to be considered.* Relevant factors indicating that the EAG has substantial business activities in the foreign country when compared to the total business activities of the EAG include, but are not limited to, the factors set forth below. The presence or absence of any factor, or of a particular number of factors, is not determinative. Moreover, the weight given to any factor (whether or not set forth below) depends on the particular case. Relevant factors include, but are not limited to—

(A) *Historical presence.* The conduct of continuous business activities in the foreign country by EAG members prior to the acquisition;

(B) *Operational activities.* Business activities of the EAG in the foreign country occurring in the ordinary course of the active conduct of one or more trades or businesses, involving—

(1) Property located in the foreign country which is owned by members of the EAG;

(2) The performance of services by individuals in the foreign country who are employed by members of the EAG; and

(3) Sales to customers in the foreign country by EAG members;

(C) *Management activities.* The performance in the foreign country of substantial managerial activities by EAG members' officers and employees who are based in the foreign country;

(D) *Ownership.* A substantial degree of ownership of the EAG by investors resident in the foreign country.

(E) *Strategic factors.* The existence of business activities in the foreign country that are material to the achievement of the EAG's overall business objectives.

(iii) *Factors not to be considered.* Any assets, activities, or income attributable to a transfer or transfers disregarded under section 7874(c)(4) are not relevant factors to be considered. In addition, any assets that are temporarily located in a foreign country at any time as part of a plan a principal purpose of which is to avoid the purposes of section 7874 are not relevant factors to be considered.

(2) *Safe harbor—(i) Elements.* The EAG will be considered to have substantial business activities, after the acquisition, in the foreign country in which, or under the law of which, the acquiring foreign entity was created or organized, when compared to the total business activities of the EAG, if paragraphs (d)(2)(ii), (iii), and (iv) of this section apply.

(ii) *Employees.* This paragraph (d)(2)(ii) applies if, after the acquisition, the group employees based in the foreign country account for at least 10 percent (by headcount and compensation) of total group employees.

(iii) *Assets.* This paragraph (d)(2)(iii) applies if, after the acquisition, the total value of the group assets located in the foreign country is at least 10 percent of the total value of all group assets.

(iv) *Sales.* This paragraph (d)(2)(iv) applies if, during the testing period, the group sales made in the foreign country accounted for at least 10 percent of total group sales.

(3) *Definitions and application of rules.* For purposes of paragraph (d) of this section—

(i) The term *group employee* means a common law employee of one or more members of the EAG who worked full time (meaning normally 35 or more hours per week) throughout the testing

period. An independent contractor performing activities on behalf of an EAG member is not a group employee. A group employee is considered to be based in a country only if the group employee spent more time providing services in such country than in any other country throughout the testing period and continues to provide services in such country immediately after the acquisition. The compensation of a group employee is determined in United States dollars and, in the case of compensation denominated in a foreign currency, translated into United States dollars using the weighted average exchange rate for the taxable year, as defined in § 1.989(b)-1.

(ii) The term *group assets* means tangible property used or held for use in the active conduct of a trade or business by a member of the EAG. An item of tangible personal property is considered to be located in a country only if such item was physically present in such country for more time than in any other country during the testing period. The total value of group assets is determined for purposes of this paragraph on the last day of the testing period, on a gross basis (that is, not reduced by liabilities), measured by either tax book value or fair market value, but not both, in United States dollars translated if necessary at the spot rate determined under the principles of § 1.988-1(d)(1), (2) and (4). Group assets do not include property located in a country by reason of a transfer, or a change of geographic location, pursuant to a plan a principal purpose of which is to avoid the application of section 7874. In addition, intangible assets are not taken into account (in either the numerator or denominator) in calculating the amount of group assets.

(iii) The term *group sales* means sales and the provision of services by members of the EAG, measured by gross receipts from such sales and services, in United States dollars (determined, in the case of gross receipts denominated in a foreign currency, using the weighted average exchange rate for the taxable year, as defined in Treas. Reg. § 1.989(b)-1). A group sale is considered to be made in a country only if the services, goods or other property trans-

ferred by such sale are sold for use, consumption or disposition in such country.

(iv) If one or more members of the EAG own capital or profits interests in a partnership, the proportionate amount of activities, employees, assets, income and sales of such partnership are considered to be activities, employees, assets, income and sales of the member or members of the EAG. A partner's proportionate share shall be determined under the rules and principles of sections 701 through 706 and the regulations thereunder.

(v) The term *testing period* means the 12 month period ending on the last day of the EAG's monthly or quarterly management accounting period in which the acquisition is completed and the term *after the acquisition* means, for purposes of paragraphs (d)(1)(i) and (d)(2)(ii) and (iii) of this section, the last day of the testing period.

(4) *Examples.* The application of paragraph (d)(1) of this section is illustrated by the following examples of business activities of an EAG in a foreign country after an acquisition described in section 7874(a)(2)(B)(i). In each example, the acquiring foreign entity is incorporated in Country A. Paragraph (d)(2) of this section does not apply to any of the examples. The examples are not intended to allow any inferences to be drawn as to whether the presence or absence, in a particular case, of one or more facts described in an example is determinative as to whether an EAG does, or does not, have substantial business activities in the relevant foreign country when compared to the total business activities of the EAG. The examples read as follows:

Example 1. Administrative activities and some customer services. (i) *Facts.* Group employees based in Country A regularly perform administrative, back office services for other EAG members, and regularly provide customer service globally via telephone and e-mail at a communications center located in Country A. After the acquisition, fewer than 2% of group employees are based in Country A. Less than 3% of group sales were made in Country A in the 12-month period ending on the date of the acquisition. The total value of group assets located in Country A on the date of the acquisition is approximately 2% of total group assets. None of the EAG's senior managers are based in Country A.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG does not have substantial business activities in Country A when compared to the total business activities of the EAG.

Example 2. Manufacturing in foreign country.

(i) *Facts.* EAG members own and have continuously operated a manufacturing facility and warehouses in Country A for several years prior to the acquisition. The goods produced in Country A represented approximately 2% of the total value of the EAG's production of finished goods in the 12-month period ending on the date of the acquisition. Group employees based in Country A also regularly perform back office services for other EAG members. Fewer than 5% of group employees were based in Country A during the 12-month period ending after the acquisition. Less than 2% of group sales were made in Country A during the 12-month period ending after the acquisition. The total value of group assets located in Country A after the acquisition is approximately 4% of total group assets. None of the EAG's senior managers are based in Country A.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG does not have substantial business activities in Country A when compared to the total business activities of the EAG.

Example 3. Financial services group; real estate in foreign country.

(i) *Facts.* The EAG's main line of business is financial services. Group employees based in Country A regularly perform back office services for other EAG members. Fewer than 5% of group employees were based in Country A during the 12-month period ending on the date of the acquisition. Less than 3% of group sales were made in Country A during the same period. However, the total value of group assets located in Country A after the acquisition is more than 10% of the value of total group assets, due to the fact that EAG members purchased a substantial amount of commercial and residential real estate in Country A during the 24 months preceding the acquisition. The management of the real estate is performed by an unrelated independent agent. Most of the EAG's senior managers are based outside Country A. The EAG's real estate portfolio in Country A was not acquired pursuant to a strategic plan for one or more of the EAG's worldwide lines of business, nor are the EAG's business activities in Country A material to the achievement of the EAG's overall business objectives.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG does not have substantial business activities in Country A when compared to the total business activities of the EAG.

Example 4. Foreign group merging with larger U.S. group.

(i) *Facts.* The Country A corporation that is the parent entity in the EAG acquired a domestic corporation and its sub-

sidaries pursuant to a merger agreement. Before the merger, the stock of both the Country A corporation and the domestic corporation was publicly traded in their respective countries of incorporation. The two groups were competitors in the same global line of business for many years preceding the merger. The merger was prompted by a third group's attempt to obtain control of the domestic corporation and its subsidiaries without the consent of the management of the domestic corporation. After the merger, the Country A corporation is more than 60% owned by former shareholders of the domestic corporation, due to the fact that the domestic corporation was significantly more valuable than the Country A corporation. After the merger, the stock of the Country A corporation is publicly traded on stock exchanges in both Country A and the United States. Group employees based in Country A perform all of the functions involved in the EAG's overall business activities, including headquarters and senior management functions. After the merger, approximately 11% of group employees are based in Country A, the total value of group assets located in Country A is approximately 10% of the value of total group assets, and the estimated percentage of group sales that will be made in Country A during the year following the merger is approximately 7%.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG has substantial business activities in Country A when compared to the total business activities of the EAG.

Example 5. Relocation of business to foreign country.

(i) *Facts.* The EAG's business involves advanced technology. The controlling shareholders of the Country A corporation that is the parent entity in the EAG, and the senior managers of the EAG, are resident in Country A. The controlling shareholders originally established DC, a domestic corporation, which established its head office in City B in the United States, where a leading institute of technology is located. Part of DC's business strategy was to hire research personnel who had been trained at the institute of technology and had settled in City B. DC hired 10 researchers who worked at DC's premises in City B. DC also established FS, a wholly owned Country A subsidiary, which hired research personnel in Country A to perform research and product development functions at FS's premises in Country A. Subsequently, the senior managers and controlling shareholders adopted a new business strategy involving the closure of the U.S. operations and the transfer of DC's business and FS's stock to FP, a new Country A corporation, with the result of centering the EAG's business in Country A. Pursuant to the new strategy, DC terminated the employment of seven researchers and the lease on its City B premises, relocated the other

three researchers from City B to Country A, and transferred its remaining assets, including the stock of FS, to FP in exchange for more than 80% of the stock of FP. After the acquisition, substantially all of the group employees were based in Country A, and substantially all of the group assets were located in Country A.

(i) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG has substantial business activities in Country A when compared to the total business activities of the EAG.

(e) *Acquisition by publicly traded foreign partnership—(1) Treatment as a foreign corporation.* For purposes of applying section 7874(a)(2)(B) and this section, a publicly traded foreign partnership shall be treated as a foreign corporation created or organized in, or under the laws of, the foreign country in which, or under the laws of which, such partnership was created or organized, and interests in such partnership shall be treated as stock of such foreign corporation. In determining whether the publicly traded foreign partnership is a surrogate foreign corporation, the publicly traded foreign partnership will be treated as a member of the EAG, if the requirements of section 7874(c)(1) are met. If this paragraph is applicable and the provisions of section 7874(a)(2)(B) are satisfied such that the foreign entity making the acquisition is a surrogate foreign corporation to which section 7874(b) applies, the foreign entity shall be treated as a domestic corporation for purposes of the Internal Revenue Code. See paragraph (e)(3) of this section for the deemed treatment of the change in form from a foreign partnership to a domestic corporation. If this paragraph is applicable and the provisions of section 7874(a)(2)(B) are satisfied such that the foreign entity making the acquisition is a surrogate foreign corporation to which section 7874(b) does not apply, the foreign entity shall continue to be a foreign partnership for purposes of the Internal Revenue Code, but the tax treatment of the expatriated entity shall be governed by section 7874(a)(1). If this paragraph is applicable, but the provisions of section 7874(a)(2)(B) are not satisfied such that the foreign partnership making the acquisition is not a surrogate foreign corporation, the status of the publicly traded for-

ign partnership will not be affected by section 7874 or § 1.7874-2T.

(2) *Publicly traded foreign partnership.* For purposes of this section, the term *publicly traded foreign partnership* means any foreign partnership that would, but for the application of section 7704(c), be treated as a corporation under section 7704 at any time during the two-year period following the partnership's completion of an acquisition described in section 7874(a)(2)(B)(i).

(3) *Deemed treatment of change from foreign partnership to domestic corporation.* Except for purposes of determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B) and § 1.7874-2T, a foreign partnership that is treated as a domestic corporation pursuant to the application of paragraph (e)(1) of this section and the application of section 7874(b) and § 1.7874-2T shall, immediately before commencement of the acquisition, be treated as transferring all of its assets and liabilities to a newly formed domestic corporation in exchange for the stock of the domestic corporation, and distributing such stock to its partners in liquidation of their interests in the partnership. The tax treatment of the transaction shall be determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(4) *Disregard of deemed acquisition.* For purposes of paragraph (e)(1) of this section, a publicly traded foreign partnership's deemed acquisition of assets and liabilities under § 1.708-1(b)(4) is not a direct or indirect acquisition of properties to which section 7874(a)(2)(B)(i) could apply.

(5) *Examples.* The application of this paragraph is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003, and that any foreign partnership referred to in an example is not treated as a corporation under section 7704. The examples read as follows:

Example 1. Foreign hybrid entity; public trading of ownership interests on stock market following triangular merger. (i) *Facts.* The stock of DP, a domestic corporation, is publicly traded on stock exchange SE. Pursuant to a

plan, DP and an unrelated person form a foreign subsidiary entity, FQ, under the laws of foreign country X, transferring a minimal amount of cash to FQ in the process. DP owns 99.9% of FQ and the unrelated party owns 0.1% of FQ. FQ is a limited liability company and is a foreign eligible entity under § 301.7701-2. FQ makes an election under § 301.7701-3 to be treated as a partnership for Federal income tax purposes as of the date of its formation. FQ forms a wholly owned domestic corporation, DS, under the laws of State A. Under a merger agreement and State A law, DS merges into DP, with DP surviving the merger as a wholly owned subsidiary of FQ and the former shareholders of DP receiving ownership interests in FQ in exchange for their DP stock. On the day of the merger, the stock of DP ceases to be listed on stock exchange SE. Trading of ownership interests of FQ on stock exchange SE commences on the day after the day of the merger. FQ, however, is not treated as a corporation under section 7704, due to the application of section 7704(c). After the acquisition, the corporate group owned by FQ does not have substantial business activities in foreign country X when compared to its total business activities.

(i) *Analysis.* FQ is a publicly traded foreign partnership under paragraph (e)(1) of this section. For purposes of determining whether FQ is a surrogate foreign corporation under section 7874(a)(2)(B), FQ is considered to be a foreign corporation rather than a foreign partnership, and ownership interests in FQ are considered to be stock of FQ. Therefore, on the basis of these facts, FQ is a surrogate foreign corporation because all of the conditions stated in section 7874(a)(2)(B) are satisfied. Because the former shareholders of DP hold more than 80% of FQ's ownership interests, FQ is treated under section 7874(b) as a domestic corporation for purposes of the Internal Revenue Code. In addition, the former shareholders of DP are treated as having received stock of domestic corporation FQ in exchange for their stock of DP.

Example 2. Substantial business activities of the EAG in the foreign country of incorporation. (i) *Facts.* The facts are the same as in *Example 1* except that, after the acquisition, the EAG that includes FQ has substantial business activities in foreign country X when compared to the total business activities of the EAG under the criteria set forth in paragraph (d) of this section.

(ii) *Analysis.* For purposes of determining whether FQ is a surrogate foreign corporation under section 7874(a)(2)(B), FQ is considered to be a foreign corporation rather than a foreign partnership, and ownership interests in FQ are considered to be stock of FQ. On the basis of these facts, FQ is not a surrogate foreign corporation, because, after the acquisition, the EAG that includes FQ has substantial business activities in foreign

country X when compared to the total business activities of the EAG. Therefore, section 7874 does not apply to the acquisition, and the status of FQ as a foreign partnership is unaffected.

Example 3. Acquisition by publicly traded foreign partnership owned by former shareholders and unrelated persons. (i) *Facts.* The facts are the same as in *Example 1* except that, at the time of the merger transaction, unrelated persons who did not own any stock of DP transfer stock of a foreign corporation to FQ in exchange for 25% of the ownership interests in FQ. Former shareholders of DP receive 75% of the ownership interests in FQ.

(ii) *Analysis.* For purposes of determining whether FQ is a surrogate foreign corporation under section 7874(a)(2)(B), FQ is considered to be a foreign corporation rather than a foreign partnership, and ownership interests in FQ are considered to be stock of FQ. Therefore, on the basis of these facts, and taking into account the provisions of section 7874(c)(4), FQ is a surrogate foreign corporation, because all of the conditions stated in section 7874(a)(2)(B) are satisfied. Because the former shareholders of DP hold less than 80% of FQ's ownership interests, FQ is not treated under section 7874(b) as a domestic corporation for purposes of the Internal Revenue Code. Rather, FQ is a foreign partnership for purposes of the Internal Revenue Code, and section 7874(a)(1) applies in determining the Federal income tax liability of DP and any other expatriated entity (as defined in section 7874(a)(2)).

(f) *Options and similar interests treated as stock of the foreign acquiring corporation—(1) General rule.* For purposes of section 7874(a)(2)(B)(ii), options and interests that are similar to options held by a person by reason of holding stock in the domestic corporation or a capital or profits interest in the domestic partnership described in section 7874(a)(2)(B)(i) shall be treated as exercised. The prior sentence shall apply, however, only to the extent that the effect of such exercise is to treat the foreign entity that has made the acquisition described in section 7874(a)(2)(B)(i) as a surrogate foreign corporation under section 7874(a)(2)(B).

(2) *Interests that are similar to options.* For purposes of paragraph (f)(1) of this section, an interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.