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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9238

RIN 1545-BE94

Guidance under Section 7874 for Determining Ownership by Former Shareholders or Partners of Domestic Entities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations under section 7874 of the Internal Revenue Code (Code) relating to the disregard of certain affiliate-owned stock in determining whether a corporation is a surrogate foreign corporation under section 7874(a)(2)(B) of the Code. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register.**

DATES: Effective Date: These regulations are effective December 28, 2005.

Applicability Dates: For the date of applicability, see §1.7874-1T(e).

FOR FURTHER INFORMATION CONTACT: Jefferson Vanderwolk, 202-622-3800 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

This document contains temporary amendments to 26 CFR part 1 under section 7874 of the Code relating to the determination of the percentage of stock in a foreign corporation held by former shareholders or partners of a domestic corporation or

partnership (domestic entity) by reason of holding stock or a partnership interest in the domestic entity, for purposes of determining whether the foreign corporation is a surrogate foreign corporation under section 7874(a)(2)(B).

Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is defined in section 7874(a)(2)(A) as a domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation and any U.S. person related (within the meaning of section 267(b) or 707(b)(1)) to such domestic corporation or partnership. Generally, a foreign corporation is a surrogate foreign corporation under section 7874(a)(2)(B), if, pursuant to a plan or a series of related transactions:

(i) The foreign corporation directly or indirectly acquires substantially all the properties held directly or indirectly by a domestic corporation, or substantially all the properties constituting a trade or business of a domestic partnership;

(ii) After the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by (in the case of an acquisition with respect to a domestic corporation) former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or (in the case of an acquisition with respect to a domestic partnership) by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership (ownership percentage test); and

(iii) The expanded affiliated group that includes the foreign corporation does not have business activities in the foreign country in which the foreign corporation was created or organized that are substantial when compared to the total business activities of such group.

The tax treatment of expatriated entities and surrogate foreign corporations varies depending on the level of owner continuity. If the percentage of stock (by vote or value) in the surrogate foreign corporation held by former owners of the domestic entity by reason of holding an interest in the domestic entity is 80 percent or more, the surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code. If such ownership percentage is 60 percent or more (but less than 80 percent) by vote or value, the surrogate foreign corporation is treated as a foreign corporation but any applicable corporate-level income or gain required to be recognized by the expatriated entity under section 304, 311(b), 367, 1001, 1248 or any other applicable provision with respect to the transfer or license of property (other than inventory or similar property) cannot be offset by net operating losses or credits (other than credits allowed under section 901). This treatment of an expatriated entity generally applies from the first date properties are acquired pursuant to the plan through the end of the 10-year period following the completion of the acquisition.

Section 7874(c)(2) provides that stock held by members of the expanded affiliated group which includes the foreign corporation is not taken into account for purposes of the ownership percentage test (affiliate-owned stock rule). Section 7874(c)(1) defines the term expanded affiliated group as an affiliated group defined in section 1504(a) but without regard to the exclusion of foreign corporations in section 1504(b)(3) and with a reduction of the 80 percent ownership threshold of section 1504(a) to a more-than-50 percent threshold.

The statute provides the Secretary of the Treasury significant regulatory authority. Section 7874(c)(6) authorizes the Secretary of the Treasury to prescribe such

regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and to treat stock as not stock. Section 7874(g) authorizes the Secretary of the Treasury to provide such regulations as are necessary to carry out the section.

The legislative history of section 7874 indicates that it was intended to apply to so-called inversion transactions in which a U.S. parent corporation of a multinational corporate group is replaced by a foreign parent corporation without significant change in the ultimate ownership of the group. See H.R. Conf. Rep. No. 108-755, 108th Cong., 2d Sess., at 568 (Oct. 7, 2004). The statute was also intended to apply to similar transactions in which a trade or business of a domestic partnership is transferred to a foreign corporation at least 60 percent of which is owned by former partners.

A key feature of section 7874 is the affiliate-owned stock rule. Congress intended to accomplish two main objectives with this rule. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, at 344. First, Congress intended that the ownership percentage test should be applied to prevent avoidance of the provisions when they otherwise should apply, including situations involving the use of so-called hook stock. In this context, hook stock is stock of the acquiring foreign corporation held by an entity that is at least 50 percent owned (by vote or value) directly or indirectly by the acquiring foreign corporation. If hook stock were respected as stock of the foreign corporation for purposes of section 7874(a)(2)(B)(ii), a taxpayer might implement an inversion and take the position that

section 7874 was not applicable by ensuring that hook stock accounted for over 40 percent of the value and voting power of the foreign corporation's stock.

Second, Congress intended that the affiliate-owned stock rule could operate in specified situations to prevent the section from applying to certain transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction, such as the conversion of a wholly owned domestic subsidiary into a new wholly owned controlled foreign corporation. Id. In the absence of this rule, section 7874 could apply to internal group restructuring transactions involving the transfer of a wholly owned domestic corporation (or its assets) to a wholly owned foreign corporation, without a change in the parent corporation of the group.

The IRS and Treasury Department have concluded that the affiliate-owned stock rule should not operate in a manner that allows the avoidance of section 7874 in situations where it should apply. For example, the affiliate-owned stock rule should prevent the use of hook stock to avoid section 7874. On the other hand, the IRS and Treasury Department have also concluded that the rule should not operate in a manner that would result in section 7874 applying to certain types of transactions that are outside the intended scope of the section. For example, the type of concerns that Congress meant to address in enacting section 7874 do not result from certain internal group restructuring transactions involving the transfer to a foreign corporation of the stock or assets of a domestic corporation where minority shareholders have a relatively small percentage interest in such stock or assets before and after the transaction.

In addition, the IRS and Treasury Department believe that the affiliate-owned stock rule was not intended to cause section 7874 to apply to certain acquisitive

business transactions, such as the acquisition of stock or assets of a domestic corporation by an unrelated foreign corporation where after the acquisition the former owners of the domestic entity do not own more than 50 percent (by vote or value) of the stock of any member of the expanded affiliate group. For example, the contribution of a domestic entity or its assets to a foreign joint venture corporation in exchange for a minority interest in the joint venture corporation should not result in the joint venture corporation's being treated, for purposes of the ownership percentage test, as wholly owned by the former owners of the domestic entity by operation of the affiliate-owned stock rule. In contrast, section 7874 may properly apply to the acquisition of an existing domestic joint venture entity by a foreign corporation which is at least 60 percent owned, after the acquisition, by the former owners of the acquired domestic entity. Congress intended the section to apply to transactions (other than internal group restructurings, as discussed previously) that effectively replace a domestic corporation or partnership with a foreign corporation at least 60 percent of which is held by former owners of the domestic entity.

Explanation of Provisions

The IRS and Treasury Department believe that guidance is necessary to ensure that the affiliated-owned stock rule cannot be used to avoid the application of section 7874, through the use of hook stock or otherwise, where that provision should apply. However, the IRS and Treasury Department also believe that guidance is needed to make sure that this test does not apply to certain transactions that are properly viewed as outside the scope of section 7874. Consequently, clarification is needed with respect to the application of the affiliate-owned stock rule.

The temporary regulation provides, as a general rule, that affiliate-owned stock is excluded from both the numerator and the denominator of the fraction that determines the stock ownership percentage for purposes of section 7874(a)(2)(B)(ii). This rule prevents the use of hook stock (and similar techniques) as means to remove an otherwise covered transaction from the scope of section 7874.

The temporary regulation also provides limited exceptions to the general rule pursuant to which affiliate-owned stock (other than hook stock) is included in the denominator of the fraction that determines the stock ownership percentage for purposes of section 7874(a)(2)(B)(ii) but is excluded from the numerator of that fraction. These exceptions are necessary to prevent section 7874 from applying to (1) certain transactions occurring as part of an internal group restructuring involving a domestic entity; and (2) certain acquisitive business transactions between unrelated parties where the former shareholders or partners of the domestic entity have a minority interest in the acquired properties after the acquisition.

With respect to internal group restructurings, the special rule applies where the common parent corporation owns directly or indirectly at least 80 percent of the domestic entity before the transaction, and continuing owners that are not members of the expanded affiliated group hold no more than 20 percent of the stock of the acquiring foreign corporation after the transaction.

With respect to transactions between unrelated parties, the special rule applies to the acquisition of a domestic entity or its assets by a foreign corporation where, after the acquisition, the former owners 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 expanded affiliated group that includes the acquiring foreign corporation.

The temporary regulation also provides a rule that prevents hook stock from being taken into account for purposes of (1) determining the percentage of ownership of an entity for purposes of determining whether the special rule is applicable; and (2) the application of the special rule itself.

The IRS and Treasury Department decided it was important to issue these regulations to deal with affiliate-owned stock as soon as possible. As a result, these temporary regulations are being published without further delay and with the same effective date as section 7874, which applies for taxable years ending after March 4, 2003.

Request for Comments

The IRS and Treasury Department identified internal restructurings and acquisitions by unrelated parties as categories of transactions requiring a special rule regarding affiliate-owned stock in order to prevent unintended consequences under section 7874. Comments are requested as to any other categories of transactions that may give rise to unintended consequences under section 7874 and these regulations.

The IRS and Treasury Department are considering issuing subsequent public guidance that addresses additional issues under section 7874. This guidance may address issues related to (1) the determination of whether there has been a direct or indirect acquisition of substantially all the properties held directly or indirectly by a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership; (2) the requirement that such acquisition be pursuant to a

plan or a series of related transactions; (3) the requirement, in the ownership percentage test, that ownership of stock be by reason of holding an interest in the domestic corporation or partnership; (4) the treatment of stock sold in a public offering that is related to the acquisition; (5) the requirement that the group's activities in the relevant foreign country are insubstantial when compared to the group's total business activities; (6) whether and to what extent options on stock and other similar interests are treated as stock for the purpose of determining whether a corporation is a surrogate foreign corporation; (7) the disregard of transfers of properties or liabilities if the transfers are part of a plan a principal purpose of which is to avoid the purposes of section 7874; and (8) any adjustments to the application of the section that are necessary to carry out its purposes, including adjustments necessary to prevent avoidance. The IRS and Treasury Department specifically request comments regarding appropriate rules in relation to these and other issues arising under section 7874.

The IRS and Treasury Department also are considering possible changes to §1.367(a)-3(c), which governs the tax consequences at the shareholder level of certain transactions similar to those addressed by section 7874, in light of the enactment of section 7874. Comments are requested in this regard.

Regulations Addressing Avoidance of the Purposes of Section 7874

The IRS and Treasury Department understand that taxpayers are implementing structures that result in the same overall tax consequences as structures that Congress intended to be subject to section 7874, but taxpayers are taking the position these structures are not within the scope of section 7874. For example, the IRS and Treasury Department understand that the shareholders (or partners) of a domestic corporation (or

domestic partnership) may arrange to transfer their shares (or partnership interests) to a newly-formed foreign entity for which an entity classification election under Treasury regulation §301.7701-3 is made to treat such entity as a foreign partnership for Federal tax purposes. Taxpayers may take the position that these transactions are not subject to section 7874 because the foreign entity is not a foreign corporation for Federal tax purposes and thus is not a surrogate foreign corporation under section 7874(a)(2)(B). In some cases, taxpayers further take the position that the foreign entity, the interests in which are publicly traded, is treated as a partnership for Federal tax purposes.

The IRS and Treasury Department believe that such structures have the effect of inversion transactions. Section 7874(g) grants broad regulatory authority to make adjustments to the application of section 7874 to prevent the avoidance of the purpose of section 7874 through the use of non-corporate entities or other intermediaries. In addition, sections 7805(b)(2) and (3) provide exceptions in certain situations to the general prohibition against the issuance of retroactive regulations found in section 7805(b)(1). Accordingly, the IRS and Treasury Department are considering issuing regulations, which may be retroactive, addressing these structures. The IRS and Treasury Department specifically request comments regarding appropriate rules in relation to these and other uses of intermediary entities (and other techniques, including the use of exchangeable shares) to avoid the purpose of section 7874.

Effective Date

Section 1.7874-1T applies to taxable years ending after March 4, 2003.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register.** Pursuant to section 7805(f), this Treasury decision will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this regulation is Jefferson VanderWolk, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in its development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

Authority**:** 26 U.S.C. 7805 * * *

Section 1.7874-1T also issued under 26 U.S.C. 7874(c)(6) and (g).

Par. 2. Section 1.7874-1T is added to read as follows:

§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, respectively, 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.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: December 13, 2005

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).