

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.

(3) *Example.* The application of this paragraph is illustrated by the following example. It is assumed that the transaction in the example occurs after March 4, 2003. The example reads as follows:

Example. Convertible bonds treated as stock of foreign corporation. (i) *Facts.* DT, a domestic corporation with 80 shares of stock issued and outstanding, is owned by a group of individuals. FA, a foreign corporation unrelated to DT, has 20 shares of stock issued and outstanding. Pursuant to a plan, the shareholders of DT transfer all of their shares of DT to FA in exchange for 25 newly issued shares of FA stock (with a value of \$25x) and \$55x of FA bonds that are convertible at the election of the holder into 55 shares of FA stock, for no additional consideration, at any time during the ensuing 5-year period. After the acquisition, the EAG that includes FA does not have substantial business activities in FA's country of incorporation when compared to the total business activities of the EAG.

(ii) *Analysis.* FA has indirectly acquired substantially all the properties held directly or indirectly by DT pursuant to a plan. Before the application of this paragraph (f), the former shareholders of DT own 25 shares of FA stock by reason of holding stock in DT. Accordingly, the section 7874(a)(2)(B)(ii) fraction would be 25/45, the resulting percentage would be 55%, and FA would not be a surrogate foreign corporation. Pursuant to paragraph (f)(2) of this section, the FA convertible bonds issued to the former shareholders of DT are treated as interests that are similar to options. As a result, and pursuant to paragraph (f)(1) of this section, the convertible bonds are treated as being converted into 55 shares of FA stock for purposes of section 7874(a)(2)(B)(ii). Therefore, the section 7874(a)(2)(B)(ii) fraction is 80/100, the resulting percentage is 80% and FA is a surrogate foreign corporation. In addition, pursuant to section 7874(b), FA is treated as a domestic corporation.

(g) *Change from foreign to domestic status—(1) Conversion—(i) General rule.* Except for purposes of determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B) and § 1.7874-2T, the conversion of a foreign corporation to a domestic corporation under section 7874(b) shall, immediately before commencement of the acquisition described in section 7874(a)(2)(B)(i), be treated as a reorganization described in section 368(a)(1)(F). For the consequences of the conversion, see § 1.367(b)-2(f). See also § 1.367(b)-3. The tax treatment of

all aspects of the transaction other than such conversion shall be determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine.

(ii) *Example.* The following example illustrates the application of paragraph (g)(1)(i) of this section. It is assumed that the transaction in the example occurs after March 4, 2003. The example reads as follows:

Example. Conversion treated as reorganization under section 368(a)(1)(F). (i) *Facts.* DT, a domestic corporation is owned by a group of individuals. FA, a foreign corporation unrelated to DT which has been conducting a trade or business for several years, has 20 shares of stock issued and outstanding. Pursuant to a plan, the shareholders of DT transfer all of their shares of DT to FA in exchange for 80 newly issued shares of FA stock. After the acquisition, the EAG that includes FA does not have substantial business activities in FA's country of incorporation when compared to the total business activities of the EAG.

(ii) *Analysis.* FA has indirectly acquired substantially all the properties held directly or indirectly by DT pursuant to a plan. After the acquisition, the former shareholders of DT own 80 shares of FA stock by reason of holding stock in DT. Accordingly, the section 7874(a)(2)(B)(ii) fraction is 80/100, the resulting percentage is 80%, and FA is a surrogate foreign corporation. In addition, pursuant to section 7874(b), FA is treated as a domestic corporation. Other than for purposes of determining whether FA is a surrogate foreign corporation, the conversion of FA from a foreign corporation to a domestic corporation shall, immediately before FA's acquisition of the DT stock, be treated as a reorganization under section 368(a)(1)(F). See §§ 1.367(b)-2(f) and 1.367(b)-3. The tax treatment of all other aspects of the transaction, including the acquisition of the DT stock by FA, is determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine.

(2) *Entity classification.* An entity that is treated as a domestic corporation under section 7874(b) is not an eligible entity as defined in § 301.7701-3(a) of this chapter and therefore may not elect noncorporate status.

(3) *Time of determination.* Subject to the application of the step transaction doctrine and section 7874(c)(4), the determination of whether a foreign entity is a surrogate foreign corporation is made immediately after completion of