2. Adding the following entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

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CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.367(b)–3T	1545–1666
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John M. Dalrymple,

Acting Deputy Commissioner of Internal Revenue.

Approved: December 22, 1999.

Jonathan Talisman,

Acting Assistant Secretary of the Treasury.

[FR Doc. 00–1379 Filed 1–21–00; 8:45 am]

BILLING CODE 4830–01–U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 7, and 602

[TD 8862]

RIN 1545–AI32

Stock Transfer Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations addressing the application of nonrecognition exchange provisions in Subchapter C of the Internal Revenue Code to transactions that involve one or more foreign corporations. These regulations provide guidance for taxpayers engaging in those transactions in order to determine the extent to which income shall be included and appropriate corresponding adjustments shall be made.

DATES: *Effective Date*. These regulations are effective as of February 23, 2000.

Applicability Dates. These regulations apply to section 367(b) exchanges that occur on or after February 23, 2000. However, taxpayers may choose to apply these regulations to section 367(b) exchanges that occur before February 23, 2000, as specified in § 1.367(b)–6(a)(2).

FOR FURTHER INFORMATION CONTACT: Mark D. Harris, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1271. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual reporting burden in these final regulations is 4 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 27, 1977, the IRS and Treasury issued proposed and temporary regulations under section 367(b) of the Internal Revenue Code (Code). Subsequent guidance updated and amended the 1977 temporary regulations (the 1977 regulations) several times over the next 14 years. On August 26, 1991, the IRS and Treasury issued proposed regulations §§ 1.367(b)–1 through 1.367(b)–6 (the 1991 proposed regulations). Comments to the 1991 proposed regulations were received, and a public hearing was held on November 22, 1991. In June of 1998, the IRS and Treasury issued final regulations under sections 367(a) and (b) (the 1998 regulations). The 1998 regulations addressed transactions under section 367(b) only to the extent the transactions are also subject to the stock transfer rules of section 367(a). Thus, the 1977 regulations have remained in effect to the extent not superseded by the 1998 regulations. The preamble to the 1998 regulations stated that the IRS and Treasury would issue guidance at a later date to address the portions of the 1991 proposed regulations related to section 367(b) that were not addressed in the 1998 regulations.

After consideration of the 1977 regulations and their updates and amendments, the 1991 proposed regulations and their updates and amendments, the 1998 regulations, and all comments received with respect to such regulations, the IRS and Treasury adopt §§ 1.367(b)–1 through 1.367(b)–6 as final regulations under section 367(b).

Overview

A. General Policies of Section 367(b)

Section 367(b) governs corporate restructurings under sections 332, 351, 354, 355, 356, and 361 (except to the extent described in section 367(a)(1)) in which the status of a foreign corporation as a ‘‘corporation’’ is necessary for application of the relevant nonrecognition provisions. Section 367(b) provides that a foreign corporation that is a party to one of the enumerated nonrecognition transactions shall be respected as a corporation, and thereby the parties involved in the transaction shall obtain the benefits of the applicable nonrecognition exchange provisions and their related provisions (such as section 381) (together, the Subchapter C provisions), except to the extent provided in regulations.

The principal purpose of section 367(b) is to prevent the avoidance of U.S. tax that can arise when the Subchapter C provisions apply to transactions involving foreign corporations. The potential for tax avoidance arises because of differences between the manner in which the United States taxes foreign corporations and their shareholders and the manner in which the United States taxes domestic corporations and their U.S. shareholders.

The Subchapter C provisions generally have been drafted to apply to domestic corporations and U.S. shareholders, and thus do not fully take into account the cross-border aspects of U.S. taxation (such as deferral, foreign tax credits, and section 1248). Section 367(b) was enacted to help ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation. Because determining the proper interaction of the Code's international and Subchapter C provisions is ‘‘necessarily highly technical,’’ Congress granted the Secretary broad regulatory authority to provide the ‘‘necessary or appropriate’’ rules, rather than enacting a complex statutory regime. H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975).

Accordingly, as the preamble to the 1991 proposed regulations stated, the section 367(b) regulations require adjustments or inclusions in order to prevent the material distortion of income that can occur when the Subchapter C provisions apply to an exchange involving a foreign corporation. The 1991 proposed regulations simplified the 1977 regulations and were generally favorably received by taxpayers. The final regulations adopt the 1991 proposed regulations with modifications. The modifications are based on further considerations of fairness, simplicity, and administrability.

The final regulations also incorporate the section 367(b) rules contained in the 1998 regulations. The 1998 regulations finalized portions of the 1991 proposed regulations to the extent necessary to address the overlap between section 367(b) and the section 367(a) stock transfer rules. Because the scope of the final regulations is broader than that overlap, the final regulations adopt the 1998 section 367(b) provisions in a manner appropriate to their incorporation into the final regulations.

The IRS and Treasury are also issuing other guidance under section 367(b). Temporary and proposed regulations (published elsewhere in this issue of the **Federal Register**) address the elimination of an election available to certain taxpayers under the 1977 regulations and the 1991 proposed regulations. In addition, the IRS and Treasury intend to issue other proposed regulations that provide rules regarding the combination and separation of corporate-level tax attributes in applicable section 367(b) exchanges.

B. Specific Policies in Context of Inbound Nonrecognition Transactions

Section 1.367(b)–3 addresses transactions in which a foreign corporation transfers assets to a domestic corporation pursuant to a Subchapter C provision. These transactions include a section 332 liquidation of a foreign corporation into a domestic parent corporation and an asset reorganization, such as a C, D, or F reorganization, of a foreign corporation into a domestic corporation (inbound nonrecognition transactions). Section 381 generally provides rules regarding the extent to which corporate attributes carry over in such transactions.

The principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations. This consideration has interrelated shareholder-level and corporate-level components. At the shareholder level, the section 367(b) regulations are concerned with the proper taxation of previously deferred earnings and profits. At the corporate level, the section 367(b) regulations are concerned with both the extent and manner in which tax attributes carry over in light of the variations between the Code's taxation of foreign and domestic corporations.

The section 367(b) regulations have historically focused on the carryover of earnings and profits and bases of assets, simultaneously addressing the shareholder and corporate level concerns by accounting for any necessary adjustments through an income inclusion by the U.S. shareholders of the foreign acquired corporation (and without limiting the extent to which the domestic acquiring corporation succeeds to the attributes). The 1991 proposed regulations required a U.S. shareholder of the foreign acquired corporation (or, in certain cases, a foreign subsidiary of the U.S. shareholder) to currently include in income the allocable portion of the foreign acquired corporation's earnings and profits accumulated during the U.S. shareholder's holding period (all earnings and profits amount). The requirement to include in income the all earnings and profits amount results in the taxation of previously unrepatriated earnings accumulated during a U.S. shareholder's (direct or indirect) holding period. This income inclusion prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount. However, the all earnings and profits amount inclusion does not consider tax attributes that accrue during a non-U.S. person's holding period.

Commentators criticized the scope of the 1991 proposed regulations, arguing that the all earnings and profits amount should be limited to the amount that a shareholder would include in income as a deemed dividend under section 1248. The scope of the all earnings and profits amount is broader than the section 1248 amount because, for example, the all earnings and profits amount is calculated without regard to whether the foreign corporation is a CFC and without regard to a shareholder's gain in the stock. However, this view too narrowly construes the role of section 367(b) by focusing on potential shareholder-level consequences without adequately considering the section 367(b) policy of determining the appropriate carryover of corporate-level attributes in inbound nonrecognition transactions. Thus, the final regulations retain the 1991 proposed regulations' definition of all earnings and profits amount. The final regulations also generally retain (subject to a new de minimis exception) the taxation of all exchanging U.S. shareholders in inbound nonrecognition transactions.

In finalizing these regulations, the IRS and Treasury considered whether future section 367(b) regulations should limit the extent to which tax attributes carry over from foreign to domestic corporations. Such a limitation would more directly implement the section 367(b) policy related to the carryover of attributes and, as a result, reduce the class of U.S. persons required to have an income inclusion in connection with an inbound nonrecognition transaction. Such a limitation would also enable the section 367(b) regulations to address the carryover of attributes attributable to a non-U.S. person's holding period. The IRS and Treasury request comments as to the merits of an attribute carryover limitation, as well as other approaches that could address the carryover of tax attributes related to a non-U.S. person's holding period under section 367(b).

C. Specific Policies in Context of Foreign-to-Foreign Nonrecognition Transactions and Section 355 Distributions

Section 1.367(b)–4 addresses transactions in which a foreign corporation acquires the stock or assets of another foreign corporation in an exchange described in section 351 or a section 368(a)(1)(B), (C), (D), (E), (F) or (G) reorganization (foreign-to-foreign nonrecognition transactions). Section 1.367(b)–5 provides rules regarding a distribution by a foreign corporation of the stock or securities of a domestic or foreign corporation described in section 355. The historic policy objective of section 367(b) in both of these contexts has been to preserve the potential application of section 1248. Thus, the amount that would have been recharacterized as a dividend under section 1248 upon a disposition of the stock (section 1248 amount) generally must be included in income as a dividend at the time of the section 367(b) exchange to the extent such section 1248 amount would not be preserved immediately following the section 367(b) exchange.

The final regulations do not address all of the policy considerations raised by the application of the Subchapter C provisions to transactions described in §§ 1.367(b)–4 and 1.367(b)–5. For example, current rules regarding the carryover or separation of foreign corporations' earnings and profits do not adequately consider the international aspects of the Code, most notably the foreign tax credit. Forthcoming proposed regulations will consider these issues. Until the IRS and Treasury promulgate such regulations, taxpayers should use a reasonable method (consistent with existing law and taking proper account of the purposes of the foreign tax credit regime) to determine the carryover and separation of earnings and profits and related foreign taxes.

Explanation of Provisions

The IRS received numerous comments on the 1991 proposed regulations. The following discussion summarizes the comments and changes to the 1991 proposed regulations.

A. § 1.367(b)–1(c): Notice Requirements

Section 1.367(b)–1(c) of the 1991 proposed regulations required any person that realizes income in a section 367(b) exchange to file a notice with respect to the exchange, regardless of such person's status as a U.S. person and its percentage ownership in the corporation that is a party to the section 367(b) exchange. Commentators criticized this notice requirement as overly broad. The 1998 regulations limited the notice requirement to shareholders that realize income and file a tax return under section 6012. The final regulations further revise the notice requirement and generally narrow its scope by requiring notice only with respect to persons and transactions that may be subject to an inclusion under the final regulations' operative provisions.

B. § 1.367(b)–2: Definitions and Special Rules

1. § 1.367(b)–2(d): All Earnings and Profits Amount

Section 1.367(b)–2(d) of the 1991 proposed regulations generally defined ''all earnings and profits amount'' as the allocable share of net positive earnings and profits accrued by a foreign corporation during a shareholder's holding period. The 1991 proposed regulations provided that the all earnings and profits amount is determined according to the attribution principles of section 1248. Because the section 1248 attribution rules incorporate the section 1223 holding period rules, commentators were concerned that the definition of all earnings and profits amount inappropriately included earnings and profits attributable to the holding period of non-U.S. persons by virtue of the rules of section 1223(2).

In response, the final regulations amend the definition of all earnings and profits amount to exclude amounts attributable to the holding period of non-U.S. persons. This modification applies to the extent the non-U.S. person was not directly or indirectly owned by U.S. persons with a 10 percent or greater interest when the earnings and profits accumulated. An example in the final regulations illustrates this new rule.

When applying the attribution principles of section 1248 for purposes of determining the all earnings and profits amount, the requirements of section 1248 unrelated to computing the amount of earnings and profits attributable to a shareholder's block of stock should not apply. The final regulations explicitly state this principle. The 1991 proposed regulations applied this principle, for example, when they provided that the all earnings and profits amount is calculated without regard to whether the foreign corporation is a controlled foreign corporation (CFC). The final regulations further specify that the all earnings and profits amount includes earnings attributable to an exchanging shareholder's stock, without regard to whether the exchanging shareholder owned 10 percent of the stock of the foreign acquired corporation. A new example in the final regulations illustrates these rules.

2. § 1.367(b)–2(e): Treatment of Deemed Dividends

Section 1.367(b)–2(e) of the 1991 proposed regulations provided that a deemed dividend shall be treated as an actual dividend. Thus, a deemed dividend was considered as paid out of the earnings and profits of a foreign corporation and was considered as having been paid through intermediate owners (when appropriate). One commentator noted that an inclusion under the 1991 proposed regulations could yield a different result from an inclusion under section 1248 because section 1248 treats a corporation as having paid the section 1248 amount directly to an exchanging shareholder despite any intermediate owners.

A deemed dividend under section 367(b) is distinguishable from a section 1248 inclusion because a section 1248 inclusion is not treated as a dividend at the corporate level. Thus, a corporation does not reduce its earnings and profits with regard to an inclusion under section 1248. Instead, the shareholder-level inclusion is considered eligible to be treated as previously taxed earnings and profits (PTI) upon a subsequent distribution. In light of this distinction between section 367(b) and section 1248, the final regulations retain the rule in § 1.367(b)–2(e) of the 1991 proposed regulations.

3. Final Regulation § 1.367(b)–2(j): Sections 985 Through 989

Section 1.367(b)–2(k) of the 1991 proposed regulations provided rules regarding currency exchange inclusions or adjustments that result from a section 367(b) exchange. The final regulations apply the principles of the 1991 proposed regulations, but provide the following modifications.

The 1991 proposed regulations required an acquired corporation that participates in a transaction described in section 381(a) to change its functional currency if the acquiring corporation has a different functional currency. The rule was intended to ensure that taxpayers use the correct functional currency after a section 367(b) exchange. However, functional currency is determined separately for each qualified business unit (QBU). In addition, the functional currency of a QBU of either the acquired or acquiring corporation may change as a result of a section 367(b) exchange. Accordingly, the final regulations provide that a QBU is deemed to have automatically changed its functional currency when its functional currency, as determined after a section 367(b) exchange, is different than before the exchange. Thus, the QBU is required to make appropriate adjustments under § 1.985–5.

The 1991 proposed regulations provided that, if an exchanging shareholder is required to include in income either the all earnings and profits amount or the section 1248 amount, then immediately before the exchange and solely for purposes of computing exchange gain or loss under section 986(c), the shareholder is treated as receiving a distribution of PTI from the appropriate foreign corporation. The purpose of this provision was to ensure that exchange gain or loss under section 986(c) is subject to current inclusion when the earnings of the foreign corporation are no longer deferred or to the extent a taxpayer does not retain its interest in PTI.

Section 1.367(b)–2(j)(2) of the final regulations expands the rules regarding the treatment of exchange gain or loss on PTI under section 986(c). An exchanging shareholder that is a U.S. person is required to recognize its section 986(c) gain or loss to the extent that deferral has ended with respect to a foreign corporation's earnings (as can occur in the case of an inbound or foreign-to-foreign nonrecognition transaction) or the U.S. person has a diminished interest in the PTI after the exchange (as can occur in the case of a section 355 distribution by a foreign corporation). A different rule applies when a U.S. person indirectly holds (through a foreign exchanging shareholder) its interest in the foreign corporation with regard to which the PTI inclusion is measured. In that case, the indirect U.S. shareholder does not recognize section 986(c) gain or loss at the time of the section 367(b) exchange. In order to preserve such section 986(c) gain or loss for future inclusion by the indirect U.S. shareholder, the foreign exchanging shareholder is treated as having received a distribution of the PTI.

Other rules under sections 985 through 989, such as the branch termination rules, may also apply to the transaction.

C. § 1.367(b)–3: Repatriation of Foreign Corporate Assets in Certain Nonrecognition Transactions

Section 1.367(b)–3 provides rules with respect to inbound nonrecognition transactions.

1. § 1.367(b)–3(b): Exchanges of Stock

Section 1.367(b)–3(b) of the 1991 proposed regulations generally provided that if an exchanging shareholder is either (i) a 10 percent U.S. shareholder of the foreign acquired corporation or (ii) a foreign corporation with respect to which a U.S. person is either a section 1248 shareholder or a domestic corporation that meets the stock ownership requirements of section 902, the shareholder must include in income as a deemed dividend the all earnings and profits amount attributable to its stock in the foreign acquired corporation. The final regulations generally retain this rule. However, in order to provide greater consistency among its various ownership thresholds, the final regulations revise § 1.367(b)–3(b)(ii) so that § 1.367(b)–3(b) applies to a foreign corporation with respect to which there is, in general, a 10 percent U.S. shareholder.

The 1991 proposed regulations provided that the same country dividend exception in section 954(c)(3)(A)(i) does not apply to an exchanging shareholder that is a CFC. Commentators criticized this rule, stating that a deemed dividend under section 367(b) should not be treated more harshly than an actual dividend and that taxpayers can circumvent this rule by having a lower-tier foreign corporation distribute a dividend before an asset transfer. However, unlike a dividend distribution that qualifies for the same country dividend exception, an inbound asset transfer represents a current repatriation of earnings into the United States. Accordingly, the final regulations retain the rule in the 1991 proposed regulations that the same country dividend exception does not apply to an exchanging shareholder that is a CFC.

The 1991 proposed regulations generally required the recognition of exchange gain (or loss) to the extent that an exchanging shareholder's capital account in a foreign acquired corporation appreciated (or depreciated) as a result of changes in currency exchange rates. Such gain (or loss) is reflected in the basis of assets when translated at the spot rate. The preamble to the 1991 proposed regulations invited comments regarding the calculation of such exchange gain (or loss), particularly in cases when a shareholder acquired the foreign corporate stock by purchase rather than in connection with the corporation's formation. None of the comments suggested a method for determining and tracking shareholder capital accounts. Most comments focused on the potential complexity and compliance burdens created by the rule. After considering the administrability issues associated with the exchange gain (or loss) calculation, the final regulations do not adopt the provision requiring the recognition of exchange gain (or loss) on a shareholder's capital account. However, the final regulations reserve the issue for further consideration.

Sections 7.367(b)–5(b) and 7.367(b)–7(c)(2)(ii) of the 1977 regulations, and § 1.367(b)–3(b)(2)(iii) of the 1991 proposed regulations provided an exchanging shareholder with an opportunity to recognize the gain (but not the loss) that it realizes in the exchange (taxable exchange election), rather than including the all earnings and profits amount in income as a deemed dividend. This taxable exchange election, however, is inconsistent with the policies of section 367(b) that apply to inbound transactions. These policies, as previously discussed, are unrelated to an exchanging shareholder's outside gain on its stock.

Moreover, when the all earnings and profits amount exceeds a shareholder's gain on its stock, merely limiting the shareholder's inclusion to its outside stock gain creates the potential for the duplication and importation of losses. See TAM 9003005 (September 28, 1989) (interpreting the 1977 regulations) (available at IRS Freedom of Information Act Reading Room, 1111 Constitution Avenue, NW., Washington, DC 20224). The 1991 proposed regulations attempted to address this aspect of the taxable exchange election by requiring various attributes of the foreign acquired corporation (such as basis in its assets) to be reduced (attribute reduction regime) to the extent the all earnings and profits amount exceeds an exchanging shareholder's stock gain.

However, the taxable exchange election in the 1991 proposed regulations had other shortcomings. The election added substantial complexity to the regulations by requiring timely coordination between electing shareholders and the acquiring corporation to carry out the required attribute reductions. In addition, the attribute reduction regime can be unfair in situations involving more than one exchanging U.S. shareholder. For example, consider an inbound C, D, or F reorganization involving two U.S. shareholders of the foreign acquired corporation, one that makes the taxable exchange election (because its gain on the stock is less than its all earnings and profits amount) and one that does not. In connection with the electing shareholder's taxable exchange election, the 1991 proposed regulations required a proportionate reduction in certain tax attributes of the foreign acquired corporation. This reduction effectively allowed the electing shareholder to transfer to the acquiring corporation the burden created by its decision not to include in income its full all earnings and profits amount and, thereby, to effectively shift a portion of this burden to the non-electing shareholder (that has already paid U.S. tax on its full share of the foreign corporation's earnings and profits).

Finally, a taxable exchange election is not required by the statute. Section 367(b) directs the Secretary to prescribe regulations that provide the necessary or appropriate tax consequences that should accompany the application of the Subchapter C provisions to transactions involving foreign corporations. Section 367(b)(2) specifically provides that the section 367(b) regulations may include the circumstances under which ''gain shall be recognized currently or amounts included in gross income currently as a dividend, or both * * *.'' Thus, the statute authorizes the IRS and Treasury to require an inclusion of amounts, as distinct from gain. As previously discussed, the all earnings and profits amount appropriately measures an exchanging shareholder's income inclusion in connection with an inbound nonrecognition transaction.

After balancing the above considerations against the benefits of the taxable exchange election, the final regulations do not adopt the taxable exchange election. However, in order to provide taxpayers an opportunity to comment on this change to the 1977 regulations and the 1991 proposed regulations, the IRS and Treasury are concurrently issuing temporary and proposed regulations that provide the taxable exchange election in modified form. This election permits an exchanging shareholder to elect to treat a transaction as a taxable exchange, but modifies the attribute reduction regime by limiting its application to a section 332 liquidation or to an inbound asset reorganization in which the foreign acquired corporation is wholly owned (directly or indirectly) by one U.S. person. This limited application of the attribute reduction regime eliminates the potentially unfair results that can arise when attributes are reduced in a transaction involving multiple exchanging shareholders. This also reduces (although does not eliminate) the potential for the duplication and importation of losses that can arise in the absence of attribute reduction. The temporary regulation is effective for one year from the effective date of the final regulations.

2. § 1.367(b)–3(c): Exchanges of Stock by Other U.S. Persons

Section 1.367(b)–3(c) of the 1991 proposed regulations provided a special rule for U.S. persons that are not subject to the § 1.367(b)–3(b) requirement to include in income the all earnings and profits amount (generally, shareholders owning less than 10 percent of the foreign acquired corporation, hereinafter small shareholders). The 1991 proposed regulations required these small shareholders to recognize the gain on their stock in the foreign acquired corporation. This rule was included because of administrative concerns, since small shareholders may not have sufficient information to calculate their all earnings and profits amounts. In addition, a foreign acquired corporation may not have adequate information about its small shareholders' inclusions to properly adjust its earnings and profits for the deemed dividends that would arise in these situations.

Commentators requested that the final regulations provide small shareholders the option of including in income the all earnings and profits amount, rather than recognizing the gain on their stock. In response, the final regulations include such an election, provided that a small shareholder has sufficient information to substantiate its all earnings and profits amount and provided that the small shareholder furnishes proper certification to the foreign acquired corporation (or its successor in interest) so that the corporation can properly reduce its earnings and profits. Electing small shareholders must also comply with the section 367(b) notice requirement. A less extensive section 367(b) notice procedure is available if the foreign acquired corporation has never had earnings and profits that would result in any shareholder having an all earnings and profits amount.

Commentators also requested an election that would permit a domestic acquiring corporation to include in income the all earnings and profits amounts on behalf of the foreign acquired corporation's small shareholders. The final regulations do not adopt this suggestion because of its substantial administrative difficulties. For example, it is unlikely that a publicly traded foreign corporation (or its domestic acquirer) could ascertain each small shareholder's correct holding period in the stock of the foreign acquired corporation, which would be necessary to properly determine such a cumulative all earnings and profits amount inclusion.

The final regulations also include a new de minimis exception, which applies to small shareholders whose stock in the foreign acquired corporation has a fair market value below $50,000 on the date of the exchange. These shareholders are not required to include gain or a deemed dividend under the section 367(b) regulations.

3. § 1.367(b)–3(d): Carryover of Certain Attributes

Section 1.367(b)–3(d) of the 1991 proposed regulations clarified that a domestic acquiring corporation may succeed to foreign taxes paid or accrued by a foreign acquired corporation that are eligible for credit under section 906. A domestic acquiring corporation may not succeed to any other foreign taxes paid or accrued by a foreign acquired corporation because the earnings that carry over to a domestic acquiring corporation (other than earnings related to the taxes eligible for credit under section 906) are not subject to double taxation at the corporate level. This rule is consistent with the general policy of section 367(b) to permit the carryover of corporate tax attributes only when appropriate. The final regulations retain the rules of § 1.367(b)–3(d), and add an example that illustrates their application.

D. § 1.367(b)–4: Acquisition of Foreign Corporate Stock or Assets by a Foreign Corporation in Certain Nonrecognition Transactions

Section 1.367(b)–4 of the 1991 proposed regulations addressed foreign-to-foreign nonrecognition transactions. In general, if the exchange in such a transaction results in a section 1248 shareholder of the foreign acquired corporation losing its section 1248 shareholder status, § 1.367(b)–4(b) required the exchanging shareholder to currently include its section 1248 amount in income as a deemed dividend. The 1991 proposed regulations generally did not require an income inclusion in circumstances when a section 1248 shareholder retains its status. In the case of a lower-tier transaction (where the exchanging shareholder is a foreign corporation), the section 1248 amount was not included as foreign personal holding company income (FPHCI) under section 954(c). This provision permitted deferral of the section 1248 amount by preserving such earnings and profits as earnings of the foreign corporation that is the exchanging shareholder. The final regulations retain these general rules.

1. § 1.367(b)–4(b): Recognition of Income

Section 1.367(b)–4(b) of the 1991 proposed regulations provided an exception to its general rule if an exchanging shareholder receives stock of a domestic corporation. This provision, which the 1991 proposed regulations included in response to a criticism of the 1977 regulations, was intended to provide relief in cases when a domestic acquiring corporation issues its own stock in exchange for CFC stock and succeeds to the section 1248 amount allocable to the transferor U.S. shareholder. Because § 1.367(b)–4(a) of the 1991 proposed regulations already limited the application of § 1.367(b)–4 to an acquisition by a foreign corporation, such relief was unnecessary.

Moreover, the provision inadvertently did not require an inclusion of a section 1248 amount that may not be preserved immediately after the exchange. This could occur, for example, if a foreign acquiring corporation uses the stock of its domestic parent corporation to acquire the stock or assets of a foreign target corporation from a section 1248 shareholder. Accordingly, the final regulations do not adopt the 1991 proposed regulations' provision regarding receipt of stock of a domestic corporation in a transaction described in § 1.367(b)–4.

2. § 1.367(b)–4(d): Special Rule for Applying Section 1248 to Subsequent Exchanges

The 1998 regulations revised the rules of the 1991 proposed regulations regarding the application of section 367(b) and section 1248 to exchanges that follow a § 1.367(b)–4 exchange in which an exchanging shareholder is not required to include a section 1248 amount in income. Because of the limited scope of the 1998 regulations, its rule only addressed the application of section 367(b) and section 1248 following a stock transfer by a direct U.S. shareholder. The final regulations incorporate the principles of the 1998 regulations and expand their application to the class of transactions subject to § 1.367(b)–4, including asset transfers and transactions in which the exchanging shareholder is a foreign corporation. The final regulations also address the interaction of these rules with section 964(e), by providing the extent to which they apply to subsequent section 964(e) sales and exchanges. Two new examples in the final regulations, as well as an expanded restatement of the example provided in the 1998 regulations, illustrate the application of these rules.

Commentators also requested that the IRS and Treasury clarify the carryover of earnings and profits and tax accounts in transactions where an exchanging shareholder is not required to include a section 1248 amount, as well as the application of section 902 to distributions by a foreign acquiring corporation after such a section 367(b) exchange. The IRS and Treasury will address these issues in forthcoming proposed regulations.

E. § 1.367(b)–5: Distributions of Stock Described in Section 355

1. § 1.367(b)–5(b): Distribution by a Domestic Corporation

Section 1.367(b)–5(b) of the 1991 proposed regulations generally provided that a domestic corporation must recognize gain on a section 355 distribution of foreign stock to individuals. The final regulations retain this general rule, consistent with the recently promulgated final regulations under section 367(e) (governing a section 355 distribution by a domestic corporation of foreign stock to foreign persons).

Commentators requested that the final regulations clarify the proper method for determining whether a distributee is an individual. The same issue arises under section 367(e), and the final regulations adopt the approach of the section 367(e) regulations. Thus, a distributee is presumed to be an individual except to the extent that the distributing corporation certifies that the distributee is not an individual. However, a publicly traded distributing corporation may use a reasonable analysis with respect to distributees that are not five percent shareholders of publicly traded stock to demonstrate the number of distributees that are not individuals. A reasonable analysis includes a determination of the actual number of distributees that are not individuals or a reasonable statistical analysis of shareholder records and other relevant information. Section 1.367(b)–2(k) (§ 1.367(b)–2(l) of the 1991 proposed regulations) has also been amended to adopt the look-through provisions provided in § 1.367(e)–1(b)(2) for purposes of determining the identity of distributees when the domestic distributing corporation stock is held by a partnership, trust or estate.

2. § 1.367(b)–5(c): Pro Rata Distribution by a CFC

Section 1.367(b)–5(c) of the 1991 proposed regulations provided that, when a CFC distributes stock of a controlled corporation on a pro rata basis in a section 355 transaction, a distributee must reduce its post-distribution basis in either the distributing or controlled corporation stock to the extent its section 1248 amount attributable to such corporation is reduced as a result of the distribution. To the extent the reduction of the section 1248 amount exceeds the stock basis, the distributee must include the difference in income as a deemed dividend. The final regulations retain this general rule, subject to the following refinements.

The final regulations add new § 1.367(b)–5(c)(3), which provides that the basis adjustment provided in § 1.367(b)–2(e)(3)(ii) shall not apply if a deemed dividend is included in income pursuant to § 1.367(b)–5(c). Under § 1.367(b)–2(e)(3)(ii), a shareholder's basis is increased by the amount of a deemed dividend inclusion. In the context of a § 1.367(b)–5(c) inclusion, the § 1.367(b)–2(e)(3)(ii) basis increase would undermine the purpose of the section 367(b) regulations, because the basis increase would correspondingly decrease the shareholder's built-in gain, thereby reducing the section 1248 amount that is intended to be preserved after the transaction.

Furthermore, some taxpayers commented that the § 1.367(b)–5(c)(2) basis reduction can lead to the creation of phantom gain; that is, it can leave a shareholder with a cumulative amount of post-distribution built-in gain in the stock of the distributing and controlled corporations that exceeds its predistribution built-in gain. As a result, commentators requested that a reduction in the basis in one of the corporations give rise to a corresponding increase in the basis of the stock of the other corporation. In response, § 1.367(b)–5(c)(4) of the final regulations provides a basis redistribution rule, under which the basis of the stock of the distributing or controlled corporation (as applicable) is increased by the amount of the required decrease in basis in the other stock under § 1.367(b)–5(c)(2). However, basis cannot be increased above the fair market value of the stock and also cannot be increased to the extent the increase diminishes the postdistribution section 1248 amount with respect to such stock. This basis redistribution rule also applies with regard to deemed dividend inclusions under § 1.367(b)–5(c)(2). An example in the final regulations illustrates the application of these new rules.

3. § 1.367(b)–5(d): Non-Pro Rata Distribution by Controlled Foreign Corporation

Section 1.367(b)–5(d) of the 1991 proposed regulations provided that, if a CFC distributes controlled corporation stock on a non-pro rata basis, each distributee must include in income the amount of any reduction in its section 1248 amount with regard to either the distributing or controlled corporation. For this purpose, the 1991 proposed regulations treated a shareholder of the distributing corporation that does not exchange stock in the distributing corporation for stock in the controlled corporation (non-participating shareholder) as a distributee.

The 1991 proposed regulations provided that a non-participating shareholder may make an election (taxable distribution election), under which the distributing and controlled corporations are not treated as corporations for purposes of gain (but not loss) recognition by all persons affected by the taxable status of the transaction. The preamble to the 1991 proposed regulations invited comments as to whether the benefits of the taxable distribution election to non-participating shareholders are outweighed by the potential adverse effects on the other shareholders.

In response, commentators uniformly criticized the taxable distribution election. They argued that the election was inequitable because it enabled a non-participating shareholder (who may be a small shareholder) to unilaterally and retroactively invalidate the section

355 transaction for all parties involved. Commentators also pointed out that the taxable distribution election could distort the economic incentives in cross-border restructurings by requiring participating shareholders to consider identifying and making contractual arrangements (which could include monetary arrangements) with each non-participating shareholder in order to prevent them from electing to invalidate the section 355 transaction. Commentators thus argued in favor of not adopting the taxable distribution election in the final regulations.

The taxable distribution election is also not required by the statute. Section 367(b) directs the Secretary to prescribe regulations that provide the necessary or appropriate tax consequences that should accompany the application of the Subchapter C provisions to transactions involving foreign corporations. Section 367(b)(2) specifically provides that the section 367(b) regulations ''shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a U.S. person. * * *'' Accordingly, the section 367(b) regulations may address the tax consequences of a non-pro rata distribution to both participating and non-participating shareholders. In both cases, the diminution in a shareholder's potential section 1248 amount following a section 355 transaction appropriately measures the shareholder's inclusion with regard to a section 355 transaction involving a distributing corporation that is a controlled foreign corporation. Differing results depending on whether a shareholder is a participating shareholder or a non-participating shareholder can also be viewed as artificial, given that the distinction is often merely a function of alternative planning strategies.

In light of all of the above considerations, the final regulations do not adopt the taxable distribution election. As a result, all shareholders of a CFC that distributes stock on a non-pro rata basis must include in income the amount of any reduction in their section 1248 amount with respect to either the distributing or controlled corporation.

4. Final Regulation § 1.367(b)–5(f): Exclusion of Deemed Dividend From FPHCI

Commentators noted that the 1991 proposed regulations did not automatically exclude a § 1.367(b)–5(c) or (d) deemed dividend inclusion by an exchanging foreign corporate shareholder from FPHCI. Accordingly, the deemed dividend generally would be subpart F income and currently includible in income by a U.S. shareholder of the exchanging foreign corporation. As in the case of a lower-tier foreign-to-foreign transaction described in § 1.367(b)–4, the potential application of section 1248 can be preserved by excluding the deemed dividend from FPHCI. Thus, the final regulations adopt the suggestion and provide that a § 1.367(b)–5(c) or (d) deemed dividend inclusion by a foreign corporation is not included in FPHCI under section 954(c).

5. 1991 Proposed Regulation § 1.367(b)–5(f): Adjustments to Earnings and Profits

Section 1.367(b)–5(f) of the 1991 proposed regulations provided rules regarding the allocation of earnings and profits of a foreign transferor corporation in connection with a section 355 distribution. After further consideration, the IRS and Treasury have not included § 1.367(b)–5(f) of the 1991 proposed regulations in the final regulations. Forthcoming proposed regulations will more fully consider the allocation of earnings and profits in section 355 distributions where either (or both) the distributing or controlled corporation is a foreign corporation.

F. § 1.367(b)–6: Effective Date

The final regulations apply to section 367(b) exchanges that occur on or after February 23, 2000. The preamble to the 1991 proposed regulations solicited comments on whether the final regulations should provide an election to apply the regulations retroactively to exchanges that occur on or after August 26, 1991 (the date the 1991 proposed regulations were published in the **Federal Register**). Given the length of time that has elapsed since the issuance of the 1991 proposed regulations, the IRS and Treasury do not believe that such an election would be appropriate. This determination is consistent with the 1998 revision to § 1.367(b)–2(d) of the 1991 proposed regulations, which deleted the proposed special retroactive effective date for the definition of the all earnings and profits amount. A taxpayer may, however, elect to apply the final regulations to section 367(b) exchanges that occur (or occurred) before February 23, 2000, if the due date for the taxpayer's timely filed Federal tax return (including extensions) for the taxable year in which the section 367(b) exchange occurs (or occurred) is after February 23, 2000.

Removed Provisions

These regulations finalize substantially all of the 1991 proposed regulations. In connection with the finalization of these regulations, the 1977 regulations (other than § 7.367(b)–12) and the section 367(b) provisions contained in the 1998 regulations are removed. Section 7.367(b)–12 is retained to address distributions with respect to (or a disposition of) stock that was subject to certain provisions of the 1977 regulations in effect prior to February 23, 2000.

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 also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the proposed regulations on small business.

Drafting Information. The principal author of these regulations is Mark Harris of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Parts 1 and 7

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 7, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for § 1.367(b)–2 and by adding entries in numerical order to read in part as follows:

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

Section 1.367(b)–2 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)–3 also issued under 26 U.S.C. 367(a) and (b). * * *

Section 1.367(b)–5 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)–6 also issued under 26 U.S.C. 367(a) and (b). * * *

Par. 2. Section 1.367(a)–3 is amended as follows:

1. Paragraph (d)(3) *Example 11*, paragraph (ii), the third sentence, the reference ''§ 7.367(b)–7(c)(1)(i) of this chapter'' is removed and ''§ 1.367(b)–4(b)'' is added in its place.

2. Paragraph (d)(3) *Example 11A*, paragraph (ii), the second, third and fourth sentences are removed and a sentence is added in their place.

3. Paragraph (e)(2), in the third, fourth, and fifth sentences, the parenthetical ''(as in effect before February 23, 2000; see 26 CFR part 1, revised as of April 1, 1999)'' is added immediately after ''§ 7.367(b)–7 of this chapter'' each place it appears.

4. Paragraph (g)(2)(iv), the parenthetical ''(as in effect before February 23, 2000; see 26 CFR part 1, revised April 1, 1999)'' is added immediately after ''7.367(b)–2(b) of this chapter.''

The revisions read as follows:

§ 1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.

* * * * *

(d) * * *

(3) * * *

Example 11A. * * *

(ii) *Result*. * * * Assuming § 1.367(b)–4(b) does not apply, there is no income inclusion under section 367(b), and the amount of the gain recognition agreement is $50.

Par. 3. Section 1.367(b)–0 is added to read as follows:

§ 1.367(b)–0 Table of contents.

This section lists the paragraphs contained in §§ 1.367(b)–0 through 1.367(b)–6.

(c) Use of reasonable method to comply with prior published guidance.
(1) Prior exchanges.
(2) Future exchanges.
(d) Effect of removal of attribution rules.

Par. 4. Sections 1.367(b)–1 and 1.367(b)–2 are revised to read as follows:

§ 1.367(b)–1 Other transfers.

(a) *Scope.* The regulations promulgated under section 367(b) (the section 367(b) regulations) set forth rules regarding the proper inclusions and adjustments that must be made as a result of an exchange described in section 367(b) (a section 367(b) exchange). A section 367(b) exchange is any exchange described in section 332, 351, 354, 355, 356 or 361, with respect to which the status of a foreign corporation as a corporation is relevant for determining the extent to which income shall be recognized or for determining the effect of the transaction on earnings and profits, basis of stock or securities, basis of assets, or other relevant tax attributes. Notwithstanding the preceding sentence, a section 367(b) exchange does not include a transfer to the extent the foreign corporation fails to be treated as a corporation by reason of section 367(a)(1). See § 1.367(a)–3(b)(2)(ii) for an illustration of the interaction of section 367(a) and (b).

(b) *General rules*—(1) *Rules.* The following general rules apply under the section 367(b) regulations—

(i) A foreign corporation in a section 367(b) exchange is considered to be a corporation and, as a result, all of the related provisions (*e.g.,* section 381) shall apply, except to the extent provided in the section 367(b) regulations; and

(ii) Nothing in the section 367(b) regulations shall permit—

(A) The nonrecognition of income that would otherwise be required to be recognized under another provision of the Internal Revenue Code or the regulations thereunder; or

(B) The recognition of a loss or deduction that would otherwise not be recognized under another provision of the Internal Revenue Code or the regulations thereunder.

(2) *Example.* The following example illustrates the rules of this paragraph (b):

Example—(i) *Facts.* DC, a domestic corporation, owns 90 percent of P, a partnership. The remaining 10 percent of P is owned by a person unrelated to DC. P owns all of the outstanding stock of FC, a controlled foreign corporation. FC liquidates into P.

(ii) *Result.* FC's liquidation is not a transaction described in section 332. Nothing in the section 367(b) regulations, including § 1.367(b)–2(k), permits FC's liquidation to qualify as a liquidation described in section 332.

(c) *Notice Required*—(1) *In general.* A notice under this paragraph (c) (section 367(b) notice) must be filed with regard to any person described in paragraph (c)(2) of this section. A section 367(b) notice must be filed in the time and manner described in paragraph (c)(3) of this section and must include the information described in paragraph (c)(4) of this section.

(2) *Persons subject to section 367(b) notice.* The following persons are described in this paragraph (c)(2)—

(i) A shareholder described in § 1.367(b)–3(b)(1) that realizes income in a transaction described in § 1.367(b)–3(a);

(ii) A shareholder that makes the election described in § 1.367(b)–3(c)(3);

(iii) A shareholder described in § 1.367(b)–4(b)(1)(i)(A)(*1*) or (*2*) that realizes income in a transaction described in § 1.367(b)–4(a); and

(iv) A shareholder that realizes income in a transaction described in § 1.367(b)–5(c) or 1.367(b)–5(d) and that is either—

(A) A section 1248 shareholder of the distributing or controlled corporation; or

(B) A foreign corporation with one or more shareholders that are described in paragraph (c)(2)(iv)(A) of this section.

(3) *Time and manner for filing notice*—(i) *United States persons described in § 1.367(b)–1(c)(2).* A United States person described in paragraph (c)(2) of this section must file a section 367(b) notice attached to a timely filed Federal tax return (including extensions) for the person's taxable year in which income is realized in the section 367(b) exchange. In the case of a shareholder that makes the election described in § 1.367(b)–3(c)(3), notification of such election must be sent to the foreign acquired corporation (or its successor in interest) on or before the date the section 367(b) notice is filed, so that appropriate corresponding adjustments can be made in accordance with the rules of § 1.367(b)–2(e).

(ii) *Foreign corporations described in § 1.367(b)–1(c)(2).* Each United States person listed in this paragraph (c)(3)(ii) must file a section 367(b) notice with regard to a foreign corporation described in paragraph (c)(2) of this section. Such notice must be attached to a timely filed Federal tax return (including extensions) for the United States person's taxable year in which income is realized in the section 367(b) exchange and, if the United States person is required to file a Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations), the section 367(b) notice must be attached to the Form 5471. The following persons are listed in this paragraph (c)(3)(ii)—

(A) United States shareholders (as defined in § 1.367(b)–3(b)(2)) of foreign corporations described in paragraph (c)(2)(i) of this section; and

(B) Section 1248 shareholders of foreign corporations described in paragraph (c)(2)(iii) or (iv) of this section.

(4) *Information required.* Except as provided in paragraph (c)(5) of this section, a section 367(b) notice shall include the following information—

(i) A statement that the exchange is a section 367(b) exchange;

(ii) A complete description of the exchange;

(iii) A description of any stock, securities or other consideration transferred or received in the exchange;

(iv) A statement that describes any amount required, under the section 367(b) regulations, to be taken into account as income or loss or as an adjustment to basis, earnings and profits, or other tax attributes as a result of the exchange;

(v) Any information that is or would be required to be furnished with a Federal income tax return pursuant to regulations under section 332, 351, 354, 355, 356, 361 or 368 (whether or not a Federal income tax return is required to be filed), if such information has not otherwise been provided by the person filing the section 367(b) notice;

(vi) Any information required to be furnished with respect to the exchange under sections 6038, 6038A, 6038B, 6038C or 6046, or the regulations under those sections, if such information has not otherwise been provided by the person filing the section 367(b) notice; and

(vii) If applicable, a statement that the shareholder is making the election described in § 1.367(b)–3(c)(3). This statement must include—

(A) A copy of the information the shareholder received from the foreign acquired corporation (or its successor in interest) establishing and substantiating the shareholder's all earnings and profits amount with respect to the shareholder's stock in the foreign acquired corporation; and

(B) A representation that the shareholder has notified the foreign acquired corporation (or its successor in interest) that the shareholder is making the election described in § 1.367(b)–3(c)(3).

(5) *Abbreviated notice provision.* In the case of a foreign acquired corporation that has never had earnings

and profits that would result in any shareholder having an all earnings and profits amount, a shareholder making the election described in § 1.367(b)–3(c)(3) may satisfy the information requirements of paragraph (c)(4) of this section by filing a section 367(b) notice that includes—

(i) A statement from the foreign acquired corporation (or its successor in interest) that the foreign acquired corporation has never had any earnings and profits that would result in any shareholder having an all earnings and profits amount; and

(ii) The information described in paragraphs (c)(4) (i) through (iii) of this section.

(6) *Supplemental published guidance*. The section 367(b) notice requirements may be updated or amended by revenue procedure or other published guidance.

§ 1.367(b)–2 Definitions and special rules.

(a) *Controlled foreign corporation.* The term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957 (taking into account section 953(c)).

(b) *Section 1248 shareholder.* The term *section 1248 shareholder* means any United States person that satisfies the ownership requirements of section 1248 (a)(2) or (c)(2) with respect to a foreign corporation.

(c) *Section 1248 amount*—(1) *Rule*. The term *section 1248 amount* with respect to stock in a foreign corporation means the net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder. In the case of a transaction in which the shareholder is a foreign corporation (foreign shareholder), the following additional rules shall apply—

(i) The foreign shareholder shall be deemed to be a United

States person for purposes of this paragraph (c), except that the foreign shareholder shall not be considered a United States person for purposes of determining whether the stock owned by the foreign shareholder is stock of a controlled foreign corporation, and

(ii) The foreign shareholder's holding period in the stock of the foreign corporation shall be determined by reference to the period that the foreign shareholder's section 1248 shareholders held (directly or indirectly) an interest in the foreign corporation. This paragraph (c)(1)(ii) applies in addition to the section 1248 regulations' incorporation of section 1223 holding periods, as modified by § 1.367(b)–4(d) (as applicable).

(2) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1—(i) *Facts.* DC, a domestic corporation, owns all of the outstanding stock of FC1, a controlled foreign corporation (CFC). FC1 owns all of the outstanding stock of FC2, a CFC. DC has always owned all of the stock of FC1, and FC1 has always owned all of the stock of FC2.

(ii) *Result.* Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to all of FC1's and FC2's earnings and profits. See section 1248(c)(2). Because FC1's section 1248 shareholder (DC) always indirectly held all of the stock of FC2, FC1's section 1248 amount with respect to its FC2 stock is computed by reference to all of FC2's earnings and profits.

Example 2—(i) *Facts.* DC, a domestic corporation, owns 40 percent of the outstanding stock of FC1, a foreign corporation. The other 60 percent of FC1 stock is owned (directly and indirectly) by foreign persons that are unrelated to DC. FC1 owns all of the outstanding stock of FC2, a foreign corporation. On January 1, 2001, DC purchases the remaining 60 percent of FC1 stock.

(ii) *Result.* Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to FC1's and FC2's earnings and profits that accumulated on or after January 1, 2001, the date FC1 and FC2 became controlled foreign corporations (CFCs). See section 1248(a). Because FC1 is not considered a United States person for purposes of determining whether FC2 is a CFC, FC1's section 1248 amount with respect to its FC2 stock is computed by reference to FC2's earnings and profits that accumulated on or after January 1, 2001, the date FC2 became an actual CFC.

Example 3—(i) *Facts.* FC1, a foreign corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC is a domestic corporation that is unrelated to FC1, FC2, and their direct and indirect owners. On January 1, 2001, DC purchases all of the outstanding stock of FC1.

(ii) *Result.* Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to FC1's and FC2's earnings and profits that accumulated on or after January 1, 2001, the first day DC held the stock of FC1. See section 1248(a). FC1's section 1248 amount with respect to its FC2 stock is computed by reference to FC2's earnings and profits that accumulated on or after January 1, 2001, the first day FC1's section 1248 shareholder (DC) indirectly held the stock of FC2.

Example 4—(i) *Facts.* DC, a domestic corporation, directly owns all of the outstanding stock of FC1 and FC2, controlled foreign corporations. DC has always owned all of the stock of FC1 and FC2. On January 1, 2001, DC contributes all of the stock of FC2 to FC1 in a nonrecognition exchange that does not require an income inclusion under the section 367(a) or 367(b) regulations. See §§ 1.367(a)–8 and 1.367(b)–4.

(ii) *Result.* Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to all of FC1's and FC2's earnings and profits. See section 1248(c)(2). Because FC1's section 1248 shareholder (DC) always held (directly or indirectly) all of the stock of FC2, FC1's section 1248 amount with respect to its FC2 stock is computed by reference to all of FC2's earnings and profits.

(d) *All earnings and profits amount*—(1) *General rule.* The term *all earnings and profits amount* with respect to stock in a foreign corporation means the net positive earnings and profits (if any) determined as provided under paragraph (d)(2) of this section and attributable to such stock as provided under paragraph (d)(3) of this section. The all earnings and profits amount shall be determined without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation.

(2) *Rules for determining earnings and profits*—(i) *Domestic rules generally applicable.* For purposes of this paragraph (d), except as provided in sections 312(k)(4) and (n)(8), 964 and 986, the earnings and profits of a foreign corporation for any taxable year shall be determined according to principles substantially similar to those applicable to domestic corporations.

(ii) *Certain adjustments to earnings and profits.* Notwithstanding paragraph (d)(2)(i) of this section, for purposes of this paragraph (d), the earnings and profits of a foreign corporation for any taxable year shall not include the amounts specified in section 1248(d). In the case of amounts specified in section 1248(d)(4), the preceding sentence requires that the earnings and profits for any taxable year be decreased by the net positive amount (if any) of earnings and profits attributable to activities described in section 1248(d)(4), and increased by the net reduction (if any) in earnings and profits attributable to activities described in section 1248(d)(4).

(iii) *Effect of section 332 liquidating distribution.* The all earnings and profits amount with respect to stock of a corporation that distributes all of its property in a liquidation described in section 332 shall be determined without regard to the adjustments prescribed by section 312(a) and (b) resulting from the distribution of such property in liquidation, except that gain or loss realized by the corporation on the distribution shall be taken into account to the extent provided in section 312(f)(1). See § 1.367(b)–3(b)(3)(ii) *Example 3.*

(3) *Amount attributable to a block of stock*—(i) *Application of section 1248 principles*—(A) *In general*—(*1*) *Rule.* The all earnings and profits amount with respect to stock of a foreign corporation is determined according to the attribution principles of section

1248 and the regulations thereunder. The attribution principles of section 1248 shall apply without regard to the requirements of section 1248 that are not relevant to the determination of a shareholder's pro rata portion of earnings and profits. Thus, for example, the all earnings and profits amount is determined without regard to whether the foreign corporation was a controlled foreign corporation at any time during the five years preceding the section 367(b) exchange in question, without regard to whether the shareholder owned a 10 percent or greater interest in the stock, and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years or while the corporation was a controlled foreign corporation.

(*2*) *Example.* The following example illustrates the rules of this paragraph (d)(3)(i)(A):

Example—(i) *Facts.* On January 1, 2001, DC, a domestic corporation, purchases 9 percent of the outstanding stock of FC, a foreign corporation. On January 1, 2002, DC purchases an additional 1 percent of FC stock. On January 1, 2003, DC exchanges its stock in FC in a section 367(b) exchange in which DC is required to include the all earnings and profits amount in income. FC was not a controlled foreign corporation during the entire period DC held its FC stock.

(ii) *Result.* The all earnings and profits amount with respect to DC's stock in FC is computed by reference to 9 percent of FC's earnings and profits from January 1, 2001, through December 31, 2001, and by reference to 10 percent of FC's earnings and profits from January 1, 2002, through January 1, 2003.

(B) *Foreign shareholders.* In the case of a transaction in which the exchanging shareholder is a foreign corporation (foreign shareholder), the following additional rules shall apply—

(*1*) The attribution principles of section 1248 shall apply without regard to whether the person directly owning the stock is a United States person; and

(*2*) The foreign shareholder's holding period in the stock of the foreign acquired corporation shall be determined by reference to the period that the foreign shareholder's United States shareholders (as defined in § 1.367(b)–3(b)(2)) held (directly or indirectly) an interest in the foreign acquired corporation. This paragraph (d)(3)(i)(B)(*2*) applies in addition to the section 1248 regulations' incorporation of section 1223 holding periods, as modified by paragraph (d)(3)(ii) of this section and § 1.367(b)–4(d) (as applicable).

(ii) *Limitation on amounts attributable to holding periods determined under section 1223*—(A) *Rule.* In applying the attribution principles of section 1248 and the regulations thereunder to determine the all earnings and profits amount with respect to the stock of a foreign corporation, earnings and profits attributable to a section 1223(2) holding period that relates to a period of direct ownership of the stock of the foreign corporation by a non-United States person shall not be included, except to the extent of earnings and profits attributable to a period when the stock of the foreign corporation was indirectly owned by United States shareholders (as defined in § 1.367(b)–3(b)(2)).

(B) *Example.* The following example illustrates the rules of this paragraph (d)(3)(ii):

Example—(i) *Facts.* (A) FC1 is a foreign corporation. The outstanding stock of FC1 is directly owned by the following unrelated persons: 20 percent by DP, a domestic partnership; 20 percent by DC, a domestic corporation; 20 percent by FC, a foreign corporation that is directly and indirectly owned by foreign persons; 20 percent by FP, a foreign partnership that is equally owned by 2 partners, DI, a United States citizen, and FI, a nonresident alien; and 20 percent by a variety of minority shareholders, none of whom owns, applying the ownership rules of section 958, 10 percent or more of the outstanding stock of FC (the small shareholders).

(B) FC1 owns all of the outstanding stock of FC2, a foreign corporation that is not a controlled foreign corporation subject to the rules of section 953(c). FC2 has net positive earnings and profits. In a reorganization described in section 368(a)(1)(B), DA, a domestic corporation, acquires all of the stock of FC2 from FC1 in exchange for DA voting stock.

(ii) *Result.* (A) Under section 1223(2), DA holds the stock of FC2 with a holding period that includes the period that FC2 was held by FC1. As a result, the rules of this paragraph (d)(3)(ii) apply for purposes of computing DA's all earnings and profits amount.

(B) In applying the attribution principles of section 1248, earnings and profits attributable to a section 1223(2) holding period that refers to a period of direct ownership of the stock of a foreign corporation by a non-United States person are not included, except to the extent the stock of the foreign corporation was indirectly owned by United States shareholders as defined in § 1.367(b)–3(b)(2). Accordingly, DA's all earnings and profits amount does not include the FC2 earnings and profits attributable to FC, FI, and the small shareholders. DA's all earnings and profits amount does include the FC2 earnings and profits attributable to DP, DC, and DI. See § 1.367(b)–2(k) for rules concerning the treatment of partnerships under the section 367(b) regulations.

(iii) *Exclusion of lower-tier earnings.* In applying the attribution principles of section 1248 and the regulations thereunder to determine the all earnings and profits amount with respect to stock of a foreign corporation, the earnings and profits of subsidiaries of the foreign corporation shall not be taken into account notwithstanding section 1248(c)(2).

(e) *Treatment of deemed dividends*—(1) *In general.* In certain circumstances these regulations provide that an exchanging shareholder shall include an amount in income as a deemed dividend. This paragraph provides rules for the treatment of the deemed dividend.

(2) *Consequences of dividend characterization.* A deemed dividend described in paragraph (e)(1) of this section shall be treated as a dividend for purposes of the Internal Revenue Code. The deemed dividend shall be considered as paid out of the earnings and profits with respect to which the amount of the deemed dividend was determined. Thus, for example, a deemed dividend that is determined by reference to the all earnings and profits amount or the section 1248 amount will never be considered as paid out of (and therefore will never reduce) earnings and profits specified in section 1248(d), because such earnings and profits are excluded in computing the all earnings and profits amount (under paragraph (d)(2)(ii) of this section) and the section 1248 amount (under section 1248(d) and paragraph (c)(1) of this section). If the deemed dividend is determined by reference to the earnings and profits of a foreign corporation that is owned indirectly (*i.e.*, through one or more tiers of intermediate owners) by the person that is required to include the deemed dividend in income, the deemed dividend shall be considered as having been paid by such corporation to such person through the intermediate owners, rather than directly to such person.

(3) *Ordering rules.* In the case of an exchange of stock in which the exchanging shareholder is treated as receiving a deemed dividend from a foreign corporation, the following ordering rules concerning the timing, treatment, and effect of such a deemed dividend shall apply. See also paragraph (j)(2) of this section.

(i) For purposes of the section 367(b) regulations, the gain realized by an exchanging shareholder shall be determined before increasing (as provided in paragraph (e)(3)(ii) of this section) the basis in the stock of the foreign corporation by the amount of the deemed dividend.

(ii) Except as provided in paragraph (e)(3)(i) of this section, the deemed dividend shall be considered to be received immediately before the exchanging shareholder's receipt of consideration for its stock in the foreign corporation, and the shareholder's basis in the stock exchanged shall be increased by the amount of the deemed dividend. Such basis increase shall be taken into account before determining the gain otherwise recognized on the exchange (for example, under section 356), the basis that the exchanging shareholder takes in the property that it receives in the exchange (under section 358(a)(1)), and the basis that the transferee otherwise takes in the transferred stock (under section 362).

(iii) Except as provided in paragraph (e)(3)(i) of this section, the earnings and profits of the appropriate foreign corporation shall be reduced by the deemed dividend amount before determining the consequences of the recognition of gain in excess of the deemed dividend amount (for example, under section 356(a)(2) or sections 356(a)(1) and 1248).

(4) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. DC, a domestic corporation, exchanges stock in FC, a foreign corporation, in a section 367(b) exchange in which DC includes the all earnings and profits amount in income as a deemed dividend. Under paragraph (e)(2) of this section, a deemed dividend is treated as a dividend for purposes of the Internal Revenue Code. As a result, if the requirements of section 902 are met, DC may qualify for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 2. DC, a domestic corporation, exchanges stock in FC1, a foreign corporation that is a controlled foreign corporation, in a transaction in which DC is required to include the section 1248 amount in income as a deemed dividend. A portion of the section 1248 amount is determined by reference to the earnings and profits of FC1 (the upper-tier portion of the section 1248 amount), and the remainder of the section 1248 amount is determined by reference to the earnings and profits of FC2, which is a wholly owned foreign subsidiary of FC1 (the lower-tier portion of the section 1248 amount). Under paragraph (e)(2) of this section, DC computes its deemed paid foreign tax credit as if the lower-tier portion of the section 1248 amount were distributed as a dividend by FC2 to FC1, and as if such portion and the upper-tier portion of the section 1248 amount were then distributed as a dividend by FC1 to DC.

Example 3. DC, a domestic corporation, exchanges stock in FC, a foreign corporation that is a controlled foreign corporation, in a transaction in which DC realizes gain of $100 (prior to the application of the section 367(b) regulations). In connection with the transaction, DC is required to include $40 in income as a deemed dividend under the section 367(b) regulations. In addition to receiving property permitted to be received under section 354 without the recognition of gain, DC also receives cash in the amount of $70. Under paragraph (e)(3) of this section, the $40 deemed dividend increases DC's basis in its FC stock before determining the gain to be recognized under section 56. Thus, in applying section 356, DC is considered to realize $60 of gain on the exchange, all of which is recognized under section 356(a)(1).

(f) *Deemed asset transfer and closing of taxable year in certain section 368(a)(1)(F) reorganizations*—(1) *Scope.* This paragraph applies to a reorganization described in section 368(a)(1)(F) in which the transferor corporation is a foreign corporation.

(2) *Deemed asset transfer.* In a reorganization described in paragraph (f)(1) of this section, there is considered to exist—

(i) A transfer of assets by the foreign transferor corporation to the acquiring corporation in exchange for stock (or stock and securities) of the acquiring corporation and the assumption by the acquiring corporation of the foreign transferor corporation's liabilities;

(ii) A distribution of such stock (or stock and securities) by the foreign transferor corporation to its shareholders (or shareholders and security holders); and

(iii) An exchange by the foreign transferor corporation's shareholders (or shareholders and security holders) of their stock (or stock and securities) for stock (or stock and securities) of the acquiring corporation.

(3) *Other applicable rules.* For purposes of this paragraph (f), it is immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuation of the foreign transferor corporation.

(4) *Closing of taxable year.* In a reorganization described in paragraph (f)(1) of this section, the taxable year of the foreign transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the reorganization if—

(i) The acquiring corporation is a domestic corporation; or

(ii) The foreign transferor corporation has effectively connected earnings and profits (as defined in section 884(d)) or accumulated effectively connected earnings and profits (as defined in section 884(b)(2)(B)(ii)).

(g) *Stapled stock under section 269B.* For rules treating a foreign corporation as a domestic corporation if it and a domestic corporation are stapled entities, see section 269B. The deemed conversion of a foreign corporation to a domestic corporation under section 269B is treated as a reorganization under section 368(a)(1)(F).

(h) *Section 953(d) domestication elections*—(1) *Effect of election.* A foreign corporation that elects under section 953(d) to be treated as a domestic corporation shall be treated for purposes of section 367(b) as transferring, as of the first day of the first taxable year for which the election is effective, all of its assets to a domestic corporation in a reorganization described in section 368(a)(1)(F). Notwithstanding paragraph (d) of this section, for purposes of determining the consequences of the reorganization under § 1.367(b)–3, the all earnings and profits amount shall not be considered to include earnings and profits accumulated in taxable years beginning before January 1, 1988.

(2) *Post-election exchanges.* For purposes of applying section 367(b) to post-election exchanges with respect to a corporation that has made a valid election under section 953(d) to be treated as a domestic corporation, such corporation shall be treated as a domestic corporation as to earnings and profits that were taken into account at the time of the section 953(d) election or which accrue after such election, and shall be treated as a foreign corporation as to earnings and profits accumulated in taxable years beginning before January 1, 1988. Thus, for example, if the section 953(d) corporation subsequently transfers its assets to a domestic corporation (other than another section 953(d) corporation) in a transaction described in section 381(a), the rules of § 1.367(b)–3 shall apply to such transaction to the extent of the section 953(d) corporation's earnings and profits accumulated in taxable years beginning before January 1, 1988.

(i) *Section 1504(d) elections.* An election under section 1504(d), which permits certain foreign corporations to be treated as domestic corporations, is treated as a transfer of property to a domestic corporation and will generally constitute a reorganization described in section 368(a)(1)(F). However, if an election under section 1504(d) is made with respect to a foreign corporation from the first day of the foreign corporation's existence, then the foreign corporation shall be treated as a domestic corporation, and the section 367(b) regulations will not apply.

(j) *Sections 985 through 989*—(1) *Change in functional currency of a qualified business unit*—(i) *Rule.* If, as a result of a transaction described in section 381(a), a qualified business unit (as defined in section 989(a)) (QBU) has a different functional currency determined under the rules of section

985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction. A QBU that is deemed to change its functional currency pursuant to this paragraph (j) must make the adjustments described in § 1.985–5.

(ii) *Example.* The following example illustrates the rule of this paragraph (j)(1):

Example—(i) *Facts.* DC, a domestic corporation, owns 100 percent of FC1, a foreign corporation. FC1 owns and operates a qualified business unit (QBU) (B1) in France, whose functional currency is the euro. FC2, an unrelated foreign corporation, owns and operates a QBU (B2) in France, whose functional currency is the dollar. FC2 acquires FC1's assets (including B1) in a reorganization described in section 368(a)(1)(C). As a part of the reorganization, B1 and B2 combine their operations into one QBU. Applying the rules of section 985(b), the functional currency of the combined operations of B1 and B2 is the euro.

(ii) *Result.* FC2's acquisition of FC1's assets is a section 367(b) exchange that is described in section 381(a). Because the functional currency of the combined operations of B1 and B2 after the exchange is the euro, B2 is deemed to have automatically changed its functional currency to the euro immediately prior to the section 367(b) exchange. B2 must make the adjustments described in § 1.985–5.

(2) *Previously taxed earnings and profits*—(i) *Exchanging shareholder that is a United States person.* If an exchanging shareholder that is a United States person is required to include in income either the all earnings and profits amount or the section 1248 amount under the provisions of § 1.367(b)–3 or 1.367(b)–4, then immediately prior to the exchange, and solely for the purpose of computing exchange gain or loss under section 986(c), the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a United States person is a distributee in an exchange described in § 1.367(b)–5(c) or (d), then immediately prior to the exchange, and solely for the purpose of computing exchange gain or loss under section 986(c), the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation to the extent such shareholder has a diminished interest in such previously taxed earnings and profits after the exchange. The exchange gain or loss recognized under this paragraph (j)(2)(i) will increase or decrease the exchanging shareholder's adjusted basis in the stock of the foreign corporation for purposes of computing gain or loss realized with respect to the stock on the transaction. The exchanging shareholder's dollar basis with respect to each account of previously taxed income shall be increased or decreased by the exchange gain or loss recognized.

(ii) *Exchanging shareholder that is a foreign corporation.* If an exchanging shareholder that is a foreign corporation is required to include in income either the all earnings and profits amount or the section 1248 amount under the provisions of § 1.367(b)–3 or 1.367(b)–4, then, immediately prior to the exchange, the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a foreign corporation is a distributee in an exchange described in § 1.367(b)–5(c) or (d), then the exchanging shareholder shall be treated as receiving (immediately prior to the exchange) a distribution of previously taxed earnings and profits from the appropriate foreign corporation. Such distribution shall be measured by the extent to which the exchanging shareholder's direct or indirect United States shareholders (as defined in section 951(b)) have a diminished interest in such previously taxed earnings and profits after the exchange.

(3) *Other rules.* See sections 985 through 989 for other currency rules that may apply in connection with a section 367(b) exchange.

(k) *Partnerships, trusts and estates.* In applying the section 367(b) regulations, stock of a corporation that is owned by a foreign partnership, trust or estate shall be considered as owned proportionately by its partners, owners, or beneficiaries under the principles of § 1.367(e)–1(b)(2). Stock owned by an entity that is disregarded as an entity separate from its owner under § 301.7701–3 is owned directly by the owner of such entity. In applying § 1.367(b)–5(b), the principles of § 1.367(e)–1(b)(2) shall also apply to a domestic partnership, trust or estate.

Par. 5. Section 1.367(b)–3 is added to read as follows:

§ 1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

(a) *Scope.* This section applies to an acquisition by a domestic corporation (the domestic acquiring corporation) of the assets of a foreign corporation (the foreign acquired corporation) in a liquidation described in section 332 or an asset acquisition described in section 368(a)(1).

(b) *Exchange of stock owned directly by a United States shareholder or by certain foreign corporate shareholders—(1) Scope.* This paragraph (b) applies in the case of an exchanging shareholder that is either—

(i) A United States shareholder of the foreign acquired corporation; or

(ii) A foreign corporation with respect to which there are one or more United States shareholders.

(2) *United States shareholder.* For purposes of this section (and for purposes of the other section 367(b) regulation provisions that specifically refer to this paragraph (b)(2)), the term *United States shareholder* means any shareholder described in section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation), and also any shareholder described in section 953(c)(1)(A) (but only if the foreign corporation is a controlled foreign corporation subject to the rules of section 953(c)).

(3) *Income inclusion*—(i) *Inclusion of all earnings and profits amount.* An exchanging shareholder shall include in income as a deemed dividend the all earnings and profits amount with respect to its stock in the foreign acquired corporation. For the consequences of the deemed dividend, see § 1.367(b)–2(e). Notwithstanding § 1.367(b)–2(e), however, a deemed dividend from the foreign acquired corporation to an exchanging foreign corporate shareholder shall not qualify for the exception from foreign personal holding company income provided by section 954(c)(3)(A)(i), although it may qualify for the look-through treatment provided by section 904(d)(3) if the requirements of that section are met with respect to the deemed dividend.

(ii) *Examples.* The following examples illustrate the rules of paragraph (b)(3)(i) of this section:

Example 1—(i) *Facts.* DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $30 in such stock. The all earnings and profits amount attributable to the FC stock owned by DC is $20, of which $15 is described in section 1248(a) and the remaining $5 is not (for example, because it accumulated prior to 1963). FC has a basis of $50 in its assets. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result.* Under paragraph (b)(3)(i) of this section, DC must include $20 in income as a deemed dividend from FC. Under section

337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b), DC takes a basis of $50 in such assets. Because the requirements of section 902 are met, DC qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 2—(i) *Facts.* DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $30 in such stock. The all earnings and profits amount attributable to the FC stock owned by DC is $75. FC has a basis of $50 in its assets. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result.* Under paragraph (b)(3)(i) of this section, DC must include $75 in income as a deemed dividend from FC. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b), DC takes a basis of $50 in such assets. Because the requirements of section 902 are met, DC qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 3—(i) *Facts.* DC, a domestic corporation, owns 80 percent of the outstanding stock of FC, a foreign corporation. DC has owned its 80 percent interest in FC since FC was incorporated. The remaining 20 percent of the outstanding stock of FC is owned by a person unrelated to DC (the minority shareholder). The stock of FC owned by DC has a value of $80, and DC has a basis of $24 in such stock. The stock of FC owned by the minority shareholder has a value of $20, and the minority shareholder has a basis of $18 in such stock. FC's only asset is land having a value of $100, and FC has a basis of $50 in the land. Gain on the land would not generate earnings and profits qualifying under section 1248(d) for an exclusion from earnings and profits for purposes of section 1248. FC has earnings and profits of $20 (determined under the rules of § 1.367(b)–2(d)(2) (i) and (ii)), $16 of which is attributable to the stock owned by DC under the rules of § 1.367(b)–2(d)(3). FC subdivides the land and distributes to the minority shareholder land with a value of $20 and a basis of $10. As part of the same transaction, in a liquidation described in section 332, FC distributes the remainder of its land to DC, and the FC stock held by DC and the minority shareholder is canceled.

(ii) *Result.* Under section 336, FC must recognize the $10 of gain it realizes in the land it distributes to the minority shareholder, and under section 331 the minority shareholder recognizes its gain of $2 in the stock of FC. Such gain is included in income by the minority shareholder as a dividend to the extent provided in section 1248 if the minority shareholder is a United States person that is described in section 1248(a)(2). Under § 1.367(b)–2(d)(2)(iii), the $10 of gain recognized by FC increases its earnings and profits for purposes of computing the all earnings and profits amount and, as a result, $8 of such increase (80 percent of $10) is considered to be attributable to the FC stock owned by DC under § 1.367(b)–2(d)(3)(i)(A)(*1*). DC's all earnings and profits amount with respect to its stock in FC is $24 (the $16 of initial all earnings and profits amount with respect to the FC stock held by DC, plus the $8 addition to such amount that results from FC's recognition of gain on the distribution to the minority shareholder). Under paragraph (b)(3)(i) of this section, DC must include the $24 all earnings and profits amount in income as a deemed dividend from FC.

Example 4—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC1 also owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC1 has a basis of $30 in such stock. The assets of FC have a value of $100. The all earnings and profits amount with respect to the FC stock owned by DC1 is $20. In a reorganization described in section 368(a)(1)(D), DC2 acquires all of the assets of FC solely in exchange for DC2 stock. FC distributes the DC2 stock to DC1, and the FC stock held by DC1 is canceled.

(ii) *Result.* DC1 must include $20 in income as a deemed dividend from FC under paragraph (b)(3)(i) of this section. Under section 361, FC does not recognize gain or loss in the assets that it transfers to DC2 or in the DC2 stock that it distributes to DC1, and under section 362(b) DC2 takes a basis in the assets that it acquires from FC equal to the basis that FC had therein. Under § 1.367(b)–2(e)(3)(ii) and section 358(a)(1), DC1 takes a basis of $50 (its $30 basis in the stock of FC, plus the $20 that was treated as a deemed dividend to DC1) in the stock of DC2 that it receives in exchange for the stock of FC. Under § 1.367(b)–2(e)(3)(iii) and section 312(a), the earnings and profits of FC are reduced by the $20 deemed dividend.

Example 5—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC1 also owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC2, a foreign corporation. The all earnings and profits amount with respect to the FC2 stock owned by FC1 is $20. In a reorganization described in section 368(a)(1)(D), DC2 acquires all of the assets and liabilities of FC2 in exchange for DC2 stock. FC2 distributes the DC2 stock to FC1, and the FC2 stock held by FC1 is canceled.

(ii) *Result.* FC1 must include $20 in income as a deemed dividend from FC2 under paragraph (b)(3)(i) of this section. The deemed dividend is treated as a dividend for purposes of the Internal Revenue Code as provided in § 1.367(b)–2(e)(2); however, under paragraph (b)(3)(i) of this section the deemed dividend cannot qualify for the exception from foreign personal holding company income provided by section 954(c)(3)(A)(i), even if the provisions of that section would otherwise have been met in the case of an actual dividend.

Example 6—(i) *Facts.* DC1, a domestic corporation, owns 99 percent of USP, a domestic partnership. The remaining 1 percent of USP is owned by a person unrelated to DC1. DC1 and USP each directly own 9 percent of the outstanding stock of FC, a foreign corporation that is not a controlled foreign corporation subject to the rule of section 953(c). In a reorganization described in section 368(a)(1)(C), DC2, a domestic corporation, acquires all of the assets and liabilities of FC in exchange for DC2 stock. FC distributes to its shareholders DC2 stock, and the FC stock held by its shareholders is canceled.

(ii) *Result.* (A) DC1 and USP are United States persons that are exchanging shareholders in a transaction described in paragraph (a) of this section. As a result, DC1 and USP are subject to the rules of paragraph (b) of this section if they qualify as United States shareholders as defined in paragraph (b)(2) of this section. Alternatively, if they do not qualify as United States shareholders as defined in paragraph (b)(2) of this section, DC1 and USP are subject to the rules of paragraph (c) of this section. Paragraph (b)(2) of this section defines the term United States shareholder to include any shareholder described in section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation). A shareholder described in section 951(b) is a United States person that is considered to own, applying the rules of section 958(a) and 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. Under section 958(b), the rules of section 318(a), as modified by section 958(b) and the regulations thereunder, apply so that, in general, stock owned directly or indirectly by a partnership is considered as owned proportionately by its partners, and stock owned directly or indirectly by a partner is considered as owned by the partnership. Thus, under section 958(b), DC1 is treated as owning its proportionate share of FC stock held by USP, and USP is treated as owning all of the FC stock held by DC1.

(B) Accordingly, for purposes of determining whether DC1 is a United States shareholder under paragraph (b)(2) of this section, DC1 is considered as owning 99 percent of the 9 percent of FC stock held by USP. Because DC1 also owns 9 percent of FC stock directly, DC1 is considered as owning more than 10 percent of FC stock. DC1 is thus a United States shareholder of FC under paragraph (b)(2) of this section and, as a result, is subject to the rules of paragraph (b) of this section. However, for purposes of determining DC1's all earnings and profits amount, DC1 is not treated as owning the FC stock held by USP. Under § 1.367(b)–2(d)(3), DC1's all earnings and profits amount is determined by reference to the 9 percent of FC stock that it directly owns.

(C) For purposes of determining whether USP is a United States shareholder under paragraph (b)(2) of this section, USP is considered as owning the 9 percent of FC stock held by DC1. Because USP also owns 9 percent of FC stock directly, USP is considered as owning more than 10 percent of FC stock. USP is thus a United States shareholder of FC under paragraph (b)(2) of this section and, as a result, is subject to the rules of paragraph (b) of this section. However, for purposes of determining USP's all earnings and profits amount, USP is not treated as owning the FC shares held by DC1.

Under § 1.367(b)–2(d)(3), USP's all earnings and profits amount is determined by reference to the 9 percent of FC stock that it directly owns.

(iii) *Recognition of exchange gain or loss with respect to capital.* [Reserved]

(4) *Reserved.* For further guidance concerning section 367(b) exchanges occurring before February 23, 2001, see § 1.367(b)–3T(b)(4).

(c) *Exchange of stock owned by a United States person that is not a United States shareholder*—(1) *Scope.* This paragraph (c) applies in the case of an exchanging shareholder that is a United States person not described in paragraph (b)(1)(i) of this section (*i.e.,* a United States person that is not a United States shareholder of the foreign acquired corporation).

(2) *Requirement to recognize gain.* An exchanging shareholder described in paragraph (c)(1) of this section shall recognize realized gain (but not loss) with respect to the stock of the foreign acquired corporation.

(3) *Election to include all earnings and profits amount.* In lieu of the treatment prescribed by paragraph (c)(2) of this section, an exchanging shareholder described in paragraph (c)(1) of this section may instead elect to include in income as a deemed dividend the all earnings and profits amount with respect to its stock in the foreign acquired corporation. For the consequences of a deemed dividend, see § 1.367(b)–2(e). Such election may be made only if—

(i) The foreign acquired corporation (or its successor in interest) has provided the exchanging shareholder information to substantiate the exchanging shareholder's all earnings and profits amount with respect to its stock in the foreign acquired corporation; and

(ii) The exchanging shareholder complies with the section 367(b) notice requirement described in § 1.367(b)–1(c), including the specific rules contained therein concerning the time and manner for electing to apply the rules of this paragraph (c)(3).

(4) *De minimis exception.* This paragraph (c) shall not apply in the case of an exchanging shareholder whose stock in the foreign acquired corporation has a fair market value of less than $50,000 on the date of the section 367(b) exchange.

(5) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1—(i) *Facts.* DC1, a domestic corporation, owns 5 percent of the outstanding stock of FC, a foreign corporation that is not a controlled foreign corporation subject to the rule of section 953(c). Persons unrelated to DC1 own the remaining 95 percent of the outstanding stock of FC. DC1 has owned its 5 percent interest in FC since FC was incorporated. DC1's stock in FC has a basis of $40,000 and a value of $100,000. The all earnings and profits amount with respect to DC1's stock in FC is $50,000. In a reorganization described in section 368(a)(1)(C), DC2, a domestic corporation, acquires all of the assets and liabilities of FC in exchange for DC2 stock. FC distributes DC2 stock to its shareholders, and the FC stock held by its shareholders is canceled.

(ii) *Alternate result 1.* If DC1 does not make the election described in paragraph (c)(3) of this section, then the general rule of paragraph (c)(2) of this section applies and DC1 must recognize its $60,000 gain in the FC stock. Under section 358(a)(1), DC1 has a $100,000 basis (its $40,000 basis in the FC stock, plus the $60,000 recognized gain) in the DC2 stock that it receives in exchange for its FC stock. Because DC1 is not a shareholder described in section 1248(a)(2), section 1248 does not apply to recharacterize any of DC1's gain as a dividend.

(iii) *Alternate result 2.* If DC1 makes a valid election under paragraph (c)(3) of this section, then DC1 must include in income as a deemed dividend the $50,000 all earnings and profits amount with respect to its FC stock. Under § 1.367(b)–2(e)(3) and section 358(a)(1), DC1 has a $90,000 basis (its $40,000 basis in the FC stock, plus the $50,000 that was treated as a deemed dividend to DC1) in the DC2 stock that it receives in exchange for its FC stock. Because DC1 owns less than 10 percent of the voting stock of FC, DC1 does not qualify for a deemed paid foreign tax credit under section 902.

Example 2—(i) *Facts.* The facts are the same as in *Example 1,* except that DC1's stock in FC has a fair market value of $48,000 on the date DC1 receives the DC2 stock.

(ii) *Result.* Because DC1's stock in FC has a fair market value of less than $50,000 on the date of the section 367(b) exchange, the de minimis exception of paragraph (c)(4) of this section applies. As a result, DC1 is not subject to the gain or income inclusion requirements of this paragraph (c).

(d) *Carryover of certain foreign taxes*—(1) *Rule.* Unused foreign tax credits allowable to the foreign acquired corporation under section 906 shall carry over to the domestic acquiring corporation and become allowable under section 901, subject to the limitations prescribed by the Internal Revenue Code (for example, sections 383, 904 and 907). The domestic acquiring corporation shall not succeed to any other foreign taxes paid or incurred by the foreign acquired corporation.

(2) *Example.* The following example illustrates the rules of this paragraph (d):

Example—(i) *Facts.* DC, a domestic corporation owns 100 percent of the outstanding stock of FC, a foreign corporation. FC has net positive earnings and profits, none of which are attributable to DC's FC stock under § 1.367(b)–2(d)(3). FC has paid foreign taxes that are not eligible for credit under section 906. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result.* The liquidation of FC into DC is a section 367(b) exchange. Thus, DC is subject to the section 367(b) regulations, and must file a section 367(b) notice pursuant to § 1.367(b)–1(c). Pursuant to the provisions of paragraph (d)(1) of this section, the foreign taxes paid by FC do not carryover to DC because FC's foreign taxes are not eligible for credit under section 906.

Par. 6. Section 1.367(b)–4 is revised to read as follows:

§ 1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) *Scope.* This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of the stock or assets of another foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1)(B), (C), (D), (E), (F) or (G). See § 1.367(a)–3(b)(2) for additional rules that may apply.

(b) *Income inclusion.* If an exchange is described in paragraph (b)(1)(i), (2)(i) or (3) of this section, the exchanging shareholder shall include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

(1) *Exchange that results in loss of status as section 1248 shareholder*—(i) *Rule.* An exchange is described in this paragraph (b)(1)(i) if—

(A) Immediately before the exchange, the exchanging shareholder is—

(*1*) A United States person that is a section 1248 shareholder with respect to the foreign acquired corporation; or

(*2*) A foreign corporation, and a United States person is a section 1248 shareholder with respect to such foreign corporation and with respect to the foreign acquired corporation; and

(B) Either of the following conditions is satisfied—

(*1*) Immediately after the exchange, the stock received in the exchange is not stock in a corporation that is a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder; or

(*2*) Immediately after the exchange, the foreign acquiring corporation (or, in the case of a reorganization described in section 368(a)(1)(B), the foreign acquired corporation) is not a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (b)(1):

Example 1—(i) *Facts.* FC1 is a foreign corporation that is owned, directly and indirectly (applying the ownership rules of section 958), solely by foreign persons. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of

FC2, a foreign corporation. Thus, under § 1.367(b)–2(a) and (b), DC is a section 1248 shareholder with respect to FC2, and FC2 is a controlled foreign corporation. Under § 1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and assumes all of the liabilities of FC2 in exchange for FC1 voting stock. The FC1 voting stock received does not represent more than 50 percent of the voting power or value of FC1's stock. FC2 distributes the FC1 stock to DC, and the FC2 stock held by DC is canceled.

(ii) *Result.* FC1 is not a controlled foreign corporation immediately after the exchange. As a result, the exchange is described in paragraph (b)(1)(i) of this section. Under paragraph (b) of this section, DC must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged.

Example 2—(i) *Facts.* The facts are the same as in *Example 1*, except that the voting stock of FC1, which is received by FC2 in exchange for its assets and distributed by FC2 to DC, represents more than 50 percent of the voting power of FC1's stock under the rules of section 957(a).

(ii) *Result.* Paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount, because FC1 is a controlled foreign corporation as to which DC is a section 1248 shareholder immediately after the exchange.

Example 3—(i) *Facts.* The facts are the same as in *Example 1,* except that FC2 receives and distributes voting stock of FP, a foreign corporation that is in control (within the meaning of section 368(c)) of FC1, instead of receiving and distributing voting stock of FC1.

(ii) *Result.* For purposes of section 367(a), the transfer is an indirect stock transfer subject to section 367(a). See § 1.367(a)–3(d)(1)(iv). Accordingly, DC's exchange of FC2 stock for FP stock under section 354 will be taxable under section 367(a) (and section 1248 will be applicable) if DC fails to enter into a gain recognition agreement in accordance with § 1.367(a)–8. Under § 1.367(a)–3(b)(2), if DC enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder, as well as section 367(a). If FP and FC1 are controlled foreign corporations as to which DC is a (direct or indirect) section 1248 shareholder immediately after the reorganization, then the section 367(b) result is the same as in *Example 2*—that is, paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount. Under these circumstances, the amount of the gain recognition agreement would equal the amount of the gain realized on the indirect stock transfer. If FP or FC1 is not a controlled foreign corporation as to which DC is a (direct or indirect) section 1248 shareholder immediately after the exchange, then the section 367(b) result is the same as in *Example 1*—that is, DC must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged. Under these circumstances, the amount of the gain recognition agreement would equal the amount of the gain realized on the indirect stock transfer, less the $20 section 1248 amount inclusion.

Example 4—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC2 owns various assets including all of the outstanding stock of FC2, a foreign corporation. The stock of FC2 has a value of $100, and DC2 has a basis of $30 in such stock. The section 1248 amount attributable to the FC2 stock held by DC2 is $20. DC2 does not own any other stock in a foreign corporation. FC1 is a foreign corporation that is unrelated to DC1, DC2 and FC2. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and liabilities of DC2 in exchange for FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes the FC1 stock to DC1, and the DC2 stock held by DC1 is canceled. DC1 properly files a gain recognition agreement under § 1.367(a)–8 to qualify for nonrecognition treatment under section 367(a) with respect to DC2's transfer of the FC2 stock to FC1. See § 1.367(a)–8(f)(2).

(ii) *Result.* Pursuant to paragraph (b)(1)(i)(A) of this section, DC2 is the exchanging shareholder that is a section 1248 shareholder with respect to FC2, the foreign acquired corporation. Immediately after the exchange, DC2 is not a section 1248 shareholder with respect to FC1, the corporation whose stock is received in the exchange (because the DC2 stock is canceled). Thus, paragraph (b)(1)(i)(B) of this section is satisfied and, as a result, paragraph (b)(1)(i) of this section applies to DC2's section 361 exchange of FC2 stock. Accordingly, under paragraph (b) of this section, DC2 must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC2 exchanges. This result arises without regard to whether FC1 and FC2 are controlled foreign corporations immediately after the exchange. For the tax treatment of DC2's transfer of assets (other than stock) to FC1, see sections 367(a)(1) and (a)(3), and the regulations thereunder. Because the exchange is also described in section 361(a) or (b), see section 367(a)(5) and any regulations thereunder. If any of the assets transferred are intangible assets, see section 367(d) and the regulations thereunder.

(2) *Receipt by exchanging shareholder of preferred or other stock in certain instances*—(i) *Rule.* An exchange is described in this paragraph (b)(2)(i) if—

(A) Immediately before the exchange, the foreign acquired corporation and the foreign acquiring corporations are not members of the same affiliated group (within the meaning of section 1504(a), but without regard to the exceptions set forth in section 1504(b), and substituting the words ''more than 50'' in place of the words ''at least 80'' in sections 1504(a)(2)(A) and (B));

(B) Immediately after the exchange, a domestic corporation meets the ownership threshold specified by section 902(a) or (b) such that it may qualify for a deemed paid foreign tax credit if it receives a distribution from the foreign acquiring corporation (directly or through tiers); and

(C) The exchanging shareholder receives preferred stock (other than preferred stock that is fully participating with respect to dividends, redemptions and corporate growth) in consideration for common stock or preferred stock that is fully participating with respect to dividends, redemptions and corporate growth, or, in the discretion of the Commissioner or the Commissioner's delegate (and without regard to whether the stock exchanged is common stock or preferred stock), receives stock that entitles it to participate (through dividends, redemption payments or otherwise) disproportionately in the earnings generated by particular assets of the foreign acquired corporation or foreign acquiring corporation.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1—(i) *Facts.* FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation, and FC2 has no outstanding preferred stock. The value of FC2 is $100 and DC has a basis of $50 in the stock of FC2. Under § 1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 and, in exchange, DC receives FC1 voting preferred stock that constitutes 10 percent of the voting stock of FC1 for purposes of section 902(a). Immediately after the exchange, FC1 and FC2 are controlled foreign corporations and DC is a section 1248 shareholder of FC1 and FC2, so paragraph (b)(1)(i) of this section does not require inclusion in income of the section 1248 amount.

(ii) *Result.* Pursuant to § 1.367(a)–3(b)(2), the transfer is subject to both section 367(a) and section 367(b). Under § 1.367(a)–3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement in accordance with § 1.367(a)–8. Even though paragraph (b)(1)(i) of this section does not apply to require inclusion in income by DC of the section 1248 amount, DC must nevertheless include the $20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2)(i) of this section. Thus, if DC enters into a gain recognition agreement, the amount is $30 (the $50 gain realized less the $20 recognized under section 367(b)). If DC fails to enter into a gain recognition agreement, it must include in income under section 367(a)(1) the $50 of gain realized ($20 of which is treated as a dividend under section 1248). Section 367(b) does not apply in such case.

Example 2—(i) *Facts.* The facts are the same as in *Example 1,* except that DC owns all of the outstanding stock of FC1 immediately before the transaction.

(ii) *Result.* Both section 367(a) and section 367(b) apply to the transfer. Paragraph (b)(2)(i) of this section does not apply to require inclusion of the section 1248 amount. Under paragraph (b)(2)(i)(A) of this section, the transaction is outside the scope of paragraph (b)(2)(i) of this section because FC1 and FC2 are, immediately before the transaction, members of the same affiliated group (within the meaning of such paragraph). Thus, if DC enters into a gain recognition agreement in accordance with § 1.367(a)–8, the amount of such agreement is $50. As in *Example 1,* if DC fails to enter into a gain recognition agreement, it must include in income $50, $20 of which will be treated as a dividend under section 1248.

Example 3—(i) *Facts.* FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. The section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 in exchange for FC1 voting stock that constitutes 10 percent of the voting stock of FC1 for purposes of section 902(a). The FC1 voting stock received by DC in the exchange carries voting rights in FC1, but by agreement of the parties the shares entitle the holder to dividends, amounts to be paid on redemption, and amounts to be paid on liquidation, that are to be determined by reference to the earnings or value of FC2 as of the date of such event, and that are affected by the earnings or value of FC1 only if FC1 becomes insolvent or has insufficient capital surplus to pay dividends.

(ii) *Result.* Under § 1.367(a)–3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement with respect to the transfer of FC2 stock to FC1. Under § 1.367(a)–3(b)(2), the exchange will be subject to the provisions of section 367(b) and the regulations thereunder to the extent that it is not subject to tax under section 367(a)(1). Furthermore, even if DC would not otherwise be required to recognize income under this section, the Commissioner or the Commissioner's delegate may nevertheless require that DC include the $20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2)(i) of this section.

(3) *Certain recapitalizations.* An exchange pursuant to a recapitalization under section 368(a)(1)(E) shall be deemed to be an exchange described in this paragraph (b)(3) if the following conditions are satisfied—

(i) During the 24-month period immediately preceding or following the date of the recapitalization, the corporation that undergoes the recapitalization (or a predecessor of, or successor to, such corporation) also engages in a transaction that would be described in paragraph (b)(2)(i) of this section but for paragraph (b)(2)(i)(C) of this section, either as the foreign acquired corporation or the foreign acquiring corporation; and

(ii) The exchange in the recapitalization is described in paragraph (b)(2)(i)(C) of this section.

(c) *Exclusion of deemed dividend from foreign personal holding company income*—(1) *Rule.* In the event the section 1248 amount is included in income as a deemed dividend by a foreign corporation under paragraph (b) of this section, such deemed dividend shall not be included as foreign personal holding company income under section 954(c).

(2) *Example.* The following example illustrates the rule of this paragraph (c):

Example—(i) *Facts.* FC1 is a foreign corporation that is owned, directly and indirectly (applying the ownership rules of section 958), solely by foreign persons. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. FC2 owns all of the outstanding stock of FC3, a foreign corporation. Under § 1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of FC3 held by FC2 is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires from FC2 all of the stock of FC3 in exchange for FC1 voting stock. The FC1 voting stock received by FC2 does not represent more than 50 percent of the voting power or value of FC1's stock.

(ii) *Result.* FC1 is not a controlled foreign corporation immediately after the exchange. Under paragraph (b)(1) of this section, FC2 must include in income, as a deemed dividend from FC3, the section 1248 amount ($20) attributable to the FC3 stock that FC2 exchanged. The deemed dividend is treated as a dividend for purposes of the Internal Revenue Code as provided in § 1.367(b)–2(e)(2); however, under this paragraph (c) the deemed dividend is not foreign personal holding company income to FC2.

(d) *Rules for subsequent exchanges*—(1) *In general.* If income is not required to be included under paragraph (b) of this section in a section 367(b) exchange described in paragraph (a) of this section (non-inclusion exchange) then, for purposes of applying section 367(b) or 1248 to subsequent exchanges, the determination of the earnings and profits attributable to an exchanging shareholder's stock received in the non-inclusion exchange shall include a computation that refers to the exchanging shareholder's pro rata interest in the earnings and profits of the foreign acquiring corporation (and, in the case of a stock transfer, the foreign acquired corporation) that accumulate after the non-inclusion exchange, as well as its pro rata interest in the earnings and profits of the foreign acquired corporation that accumulated before the non-inclusion exchange. See also section 1248(c)(2)(D)(ii). The earnings and profits attributable to the stock received by an exchanging shareholder in the non-inclusion exchange shall not include any earnings and profits of the foreign acquiring corporation that accumulated before the non-inclusion exchange. In the case of a non-inclusion exchange in which the exchanging shareholder is a foreign corporation, this paragraph (d)(1) shall also apply for purposes of determining the earnings and profits attributable to the exchanging foreign corporation's shareholders, as well as for purposes of determining the earnings and profits attributable to the exchanging foreign corporation when applying section 964(e) to subsequent sales or exchanges of the stock of the foreign acquiring corporation.

(2) *Subsequent dispositions by a foreign acquiring corporation.* In the case of an exchange by a foreign acquiring corporation that is subject to section 367(b) or 964(e) and that follows a non-inclusion exchange (as defined in paragraph (d)(1) of this section), the rules of paragraph (d)(1) of this section shall not apply. However, as a result of such a subsequent exchange, proportionate reductions shall be made to the earnings and profits that accumulated before the non-inclusion exchange and that were attributed under paragraph (d)(1) of this section. Such reductions shall be made without regard to whether gain is recognized on the subsequent sale or exchange.

(3) *Examples.* The following examples illustrate the rules of this section:

Example 1—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation. FC1 has $20 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC1's stock in FC1. DC2, a domestic corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. FC2 has $40 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC2's stock in FC2. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), DC1 transfers all of the stock of FC1 to FC2 in exchange for 40 percent of FC2 stock. DC1 enters into a five-year gain recognition agreement under the provisions of §§ 1.367(a)–3(b) and 1.367(a)–8 with respect to its transfer of FC1 stock to FC2.

(ii) *Result.* (A) DC1's transfer of FC1 to FC2 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, DC1 is not required to include in income the section 1248 amount attributable to its FC1 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges of FC2 stock, the determination of the earnings and profits attributable to DC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC1 and FC2, and that refers to 100 percent of the $20 of pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's stock in FC2 will not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248. However, paragraph (d)(1) of this section does not apply for purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC1 stock by FC2. For these purposes, the determination of the earnings and profits attributable to FC2's stock in FC1 is made under the principles of section 1248 and, as a result, includes a computation that refers to the $20 of earnings and profits attributable to FC2's section 1223(2) holding period in the FC1 stock.

(B) In the event FC2 exchanges FC1 stock in a transaction that is subject to section 367(b) or 964(e), a proportionate reduction must be made to the $20 of earnings and profits that was previously attributed under paragraph (d)(1) of this section to DC1's stock in FC2. Thus, for example, if FC2 sells 50 percent of its FC1 stock (at a time when there have been no other reductions that affect the $20 of FC1 earnings and profits), paragraph (d)(2) of this section requires DC1 to proportionately reduce the $20 of earnings and profits that was previously attributed to its FC2 stock (to $10). This reduction occurs without regard to whether FC2 recognizes gain on its sale of FC1 stock.

Example 2—(i) *Facts.* The facts are the same as in *Example 1,* except that in a reorganization described in section 368(a)(1)(C), FC1 transfers all of its assets to FC2 in exchange for 40 percent of FC2 stock. FC1 then distributes the stock of FC2 to DC1, and the FC1 stock held by DC1 is canceled. None of FC1's assets include stock.

(ii) *Result.* FC2's acquisition of FC1 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, DC1 is not required to include in income the section 1248 amount attributable to its FC1 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges, the determination of the earnings and profits attributable to DC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2, and that refers to 100 percent of the pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's stock in FC2 will not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248.

Example 3—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC3, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation, and FC1 has owned all of the stock of FC3 since FC3's formation. FC3 has $20 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC1's stock in FC1 and in the section 1248 amount attributable to FC1's stock in FC3. Such earnings and profits are similarly eligible for inclusion as a dividend attributable to FC1's stock in FC3 under section 964(e). DC2, a domestic corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. FC2 has $40 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC2's stock in FC2. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), FC1 transfers all of the stock of FC3 to FC2 in exchange for 40 percent of FC2 stock.

(ii) *Result.* (A) FC1's transfer of FC3 to FC2 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, FC1 is not required to include in income the section 1248 amount attributable to its FC3 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges of FC1 stock, the determination of the earnings and profits attributable to DC1's stock in FC1 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2 and FC3, and that refers to 100 percent of the $20 of pre-reorganization earnings and profits of FC3. The earnings and profits attributable to FC1's stock in FC2 will not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248. For purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC2 stock, the determination of the earnings and profits attributable to FC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2 and FC3, and that refers to 100 percent of the $20 of pre-reorganization earnings and profits of FC3. The earnings and profits attributable to FC1's interest in FC2 do not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. However, paragraph (d)(1) of this section does not apply for purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC3 stock by FC2. For these purposes, the determination of the earnings and profits attributable to FC2's stock in FC3 is made under the principles of section 1248 and, as a result, includes a computation that refers to the $20 of earnings and profits attributable to FC2's section 1223(2) holding period in the FC3 stock.

(B) In the event FC2 exchanges FC3 stock in a transaction that is subject to section 367(b) or 964(e), a proportionate reduction must be made to the $20 of earnings and profits that was previously attributed under paragraph (d)(1) of this section to DC1's stock in FC1 (for purposes of subsequent application of section 367(b) or 1248) as well as to FC1's stock in FC2 (for purposes of subsequent application of section 367(b) or 964(e)). Thus, for example, if FC2 sells 50 percent of its FC3 stock (at a time when there have been no other reductions that affect the $20 of FC3 earnings and profits), paragraph (d)(2) of this section requires DC1 and FC1 to proportionately reduce the $20 of earnings and profits that was previously attributed to their FC1 and FC2 stock, respectively (to $10). These reductions occur without regard to whether FC2 recognizes gain on its sale of FC3 stock.

Par. 7. Sections 1.367(b)–5 and 1.367(b)–6 are added to read as follows:

§ 1.367(b)–5 Distributions of stock described in section 355.

(a) *In general*—(1) *Scope.* This section provides rules relating to a distribution described in section 355 and to which section 367(b) applies. For purposes of this section, the terms *distributing corporation*, *controlled corporation*, and *distributee* have the same meaning as used in section 355 and the regulations thereunder.

(2) *Treatment of distributees as exchanging shareholders.* For purposes of the section 367(b) regulations, all distributees in a transaction described in paragraph (b), (c), or (d) of this section shall be treated as exchanging shareholders that realize income in a section 367(b) exchange.

(b) *Distribution by a domestic corporation*—(1) *General rule.* In a distribution described in section 355, if the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation, the following general rules shall apply—

(i) If the distributee is a corporation, then the controlled corporation shall be considered to be a corporation; and

(ii) If the distributee is an individual, then, solely for purposes of determining the gain recognized by the distributing corporation, the controlled corporation shall not be considered to be a corporation, and the distributing corporation shall recognize any gain (but not loss) realized on the distribution.

(2) *Section 367(e) transactions.* The rules of paragraph (b)(1) of this section shall not apply to a foreign distributee to the extent gain is recognized under section 367(e)(1) and the regulations thereunder.

(3) *Determining whether distributees are individuals.* All distributees in a distribution described in paragraph (b)(1) of this section are presumed to be individuals. However, the shareholder identification principles of § 1.367(e)–1(d) (including the reporting procedures in § 1.367(e)–1(d)(2) and (3)) shall apply for purposes of rebutting this presumption.

(4) *Applicable cross-references.* For rules with respect to a distributee that is a partnership, trust or estate, see § 1.367(b)–2(k). For additional rules relating to a distribution of stock of a foreign corporation by a domestic corporation, see section 1248(f) and the

regulations thereunder. For additional rules relating to a distribution described in section 355 by a domestic corporation to a foreign distributee, see section 367(e)(1) and the regulations thereunder.

(c) *Pro rata distribution by a controlled foreign corporation*—(1) *Scope.* This paragraph (c) applies to a distribution described in section 355 in which the distributing corporation is a controlled foreign corporation and in which the stock of the controlled corporation is distributed pro rata to each of the distributing corporation's shareholders.

(2) *Adjustment to basis in stock and income inclusion.* If the distributee's postdistribution amount (as defined in paragraph (e)(2) of this section) with respect to the distributing or controlled corporation is less than the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) with respect to such corporation, then the distributee's basis in such stock immediately after the distribution (determined under the normal principles of section 358) shall be reduced by the amount of the difference. However, the distributee's basis in such stock shall not be reduced below zero, and to the extent the foregoing reduction would have reduced basis below zero, the distributee shall instead include such amount in income as a deemed dividend from such corporation.

(3) *Interaction with § 1.367(b)–2(e)(3)(ii).* The basis increase provided in § 1.367(b)–2(e)(3)(ii) shall not apply to a deemed dividend that is included in income pursuant to paragraph (c)(2) of this section.

(4) *Basis redistribution.* If a distributee reduces the basis in the stock of the distributing or controlled corporation (or has an inclusion with respect to such stock) under paragraph (c)(2) of this section, the distributee shall increase its basis in the stock of the other corporation by the amount of the basis decrease (or deemed dividend inclusion) required by paragraph (c)(2) of this section. However, the distributee's basis in such stock shall not be increased above the fair market value of such stock and shall not be increased to the extent the increase diminishes the distributee's postdistribution amount with respect to such corporation.

(d) *Non-pro rata distribution by a controlled foreign corporation*—(1) *Scope.* This paragraph (d) applies to a distribution described in section 355 in which the distributing corporation is a controlled foreign corporation and in which the stock of the controlled corporation is not distributed pro rata to each of the distributing corporation's shareholders.

(2) *Treatment of certain shareholders as distributees.* For purposes of the section 367(b) regulations, all persons owning stock of the distributing corporation immediately after a transaction described in paragraph (d)(1) of this section shall be treated as distributees of such stock. For other applicable rules, see paragraph (a)(2) of this section.

(3) *Inclusion of excess section 1248 amount by exchanging shareholder.* If the distributee's postdistribution amount (as defined in paragraph (e)(2) of this section) with respect to the distributing or controlled corporation is less than the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) with respect to such corporation, then the distributee shall include in income as a deemed dividend the amount of the difference. For purposes of this paragraph (d)(3), if a distributee owns no stock in the distributing or controlled corporation immediately after the distribution, the distributee's postdistribution amount with respect to such corporation shall be zero.

(4) *Interaction with § 1.367(b)—2(e)(3)(ii)*—(i) *Limited application.* The basis increase provided in § 1.367(b)—2(e)(3)(ii) shall apply to a deemed dividend that is included in income pursuant to paragraph (d)(3) of this section only to the extent that such basis increase does not increase the distributee's basis above the fair market value of such stock and does not diminish the distributee's postdistribution amount with respect to such corporation.

(ii) *Interaction with predistribution amount.* For purposes of this paragraph (d), the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) shall be determined without regard to any basis increase permitted under paragraph (d)(4)(i) of this section.

(e) *Definitions*—(1) *Predistribution amount.* For purposes of this section, the predistribution amount with respect to a distributing or controlled corporation is the distributee's section 1248 amount (as defined in § 1.367(b)—2(c)(1)) computed immediately before the distribution (and after any section 368(a)(1)(D) transfer connected with the section 355 distribution), but only to the extent that such amount is attributable to the distributing corporation and any corporations controlled by it immediately before the distribution (the distributing group) or the controlled corporation and any corporations controlled by it immediately before the distribution (the controlled group), as the case may be, under the principles of §§ 1.1248–1(d)(3), 1.1248–2 and 1.1248–3. However, the predistribution amount with regard to the distributing group shall be computed without taking into account the distributee's predistribution amount with respect to the controlled group.

(2) *Postdistribution amount.* For purposes of this section, the postdistribution amount with respect to a distributing or controlled corporation is the distributee's section 1248 amount (as defined in § 1.367(b)–2(c)(1)) with respect to such stock, computed immediately after the distribution (but without regard to paragraph (c) or (d) of this section (whichever is applicable)). The postdistribution amount under this paragraph (e)(2) shall be computed before taking into account the effect (if any) of any inclusion under section 356(a) or (b).

(f) *Exclusion of deemed dividend from foreign personal holding company income.* In the event an amount is included in income as a deemed dividend by a foreign corporation under paragraph (c) or (d) of this section, such deemed dividend shall not be included as foreign personal holding company income under section 954(c).

(g) *Examples.* The following examples illustrate the rules of this section:

Example 1—(i) *Facts.* USS, a domestic corporation, owns 40 percent of the outstanding stock of FD, a controlled foreign corporation (CFC). USS has owned the stock since FD was incorporated, and FD has always been a CFC. USS has a basis of $80 in its FD stock, which has a fair market value of $200. FD owns 100 percent of the outstanding stock of FC, a foreign corporation. FD has owned the stock since FC was incorporated. Neither FD nor FC own stock in any other corporation. FD has earnings and profits of $0 and a fair market value of $250 (not considering its ownership of FC). FC has earnings and profits of $300, none of which is described in section 1248(d), and a fair market value of $250. In a pro rata distribution described in section 355, FD distributes to USS stock in FC worth $100; thereafter, USS's FD stock is worth $100 as well.

(ii) *Result*—(A) FD's distribution is a transaction described in paragraph (c)(1) of this section. Under paragraph (c)(2) of this section, USS must compare its predistribution amounts with respect to FD and FC to its respective postdistribution amounts. Under paragraph (e)(1) of this section, USS's predistribution amount with respect to FD or FC is its section 1248 amount computed immediately before the distribution, but only to the extent such amount is attributable to FD or FC. Under § 1.367(b)–2(c)(1), USS's section 1248 amount computed immediately before the distribution is $120, all of which is attributable to FC. Thus, USS's predistribution amount with respect to FD is $0, and its predistribution amount with respect to FC is $120. These amounts are computed as follows: If USS had sold its FD stock immediately before the transaction, it would have recognized $120 of gain ($200 fair market value $80 basis). All of the gain would have been treated as a dividend under section 1248, and all of the section 1248 amount would have been attributable to FC (based on USS's pro rata share of FC's earnings and profits (40 percent × $300)).

(B) Under paragraph (e)(2) of this section, USS's postdistribution amount with respect to FD or FC is its section 1248 amount with respect to such corporation, computed immediately after the distribution (but without regard to paragraph (c) of this section). Under § 1.367(b)–2(c)(1), USS's section 1248 amounts computed immediately after the distribution with respect to FD and FC are $60 and $0, respectively. These amounts, which are USS's postdistribution amounts, are computed as follows: Under the normal principles of section 358, USS allocates its $80 predistribution basis in FD between FD and FC according to the stock blocks' relative values, yielding a $40 basis in each block. If USS sold its FD stock immediately after the distribution, none of the resulting gain would be treated as a dividend under section 1248. If USS sold its FC stock immediately after the distribution, it would have a $60 gain ($100 fair market value—$40 basis), all of which would be treated as a dividend under section 1248.

(C) The basis adjustment and income inclusion rules of paragraph (c)(2) of this section apply to the extent of any difference between USS's postdistribution and predistribution amounts. In the case of FD, there is no difference between the two amounts and, as a result, no adjustment or income inclusion is required. In the case of FC, USS's postdistribution amount is $60 less than its predistribution amount. Accordingly, under paragraph (c)(2) of this section, USS is required to reduce its basis in its FC stock from $40 to $0 and include $20 in income as a deemed dividend from FC. Under paragraph (c)(3) of this section, the basis increase provided in § 1.367(b)–2(e)(3)(ii) does not apply with regard to the $20 deemed dividend. Under the rules of paragraph (c)(4) of this section, USS increases its basis in FD by the amount by which it decreased its basis in FC, as well as by the amount of its deemed dividend inclusion ($40 + $40 + $20 = $100).

Example 2—(i) *Facts.* USS1 and USS2, domestic corporations, each own 50 percent of the outstanding stock of FD, a controlled foreign corporation (CFC). USS1 and USS2 have owned their FD stock since it was incorporated, and FD has always been a CFC. USS1 and USS2 each have a basis of $500 in their FD stock, and the fair market value of each block of FD stock is $750. FD owns 100 percent of the outstanding stock of FC, a foreign corporation. FD owned the stock since FC was incorporated. Neither FD nor FC own stock in any other corporation. FD has earnings and profits of $0 and a fair market value of $750 (not considering its ownership of FC). FC has earnings and profits of $500, none of which is described in section 1248(d), and a fair market value of $750. In a non-pro rata distribution described in section 355, FD distributes all of the stock of FC to USS2 in exchange for USS2's FD stock.

(ii) *Result*—(A) FD's distribution is a transaction described in paragraph (d)(1) of this section. Under paragraph (d)(2) of this section, USS1 is considered a distributee of FD stock. Under paragraph (d)(3) of this section, USS1 and USS2 must compare their predistribution amounts with respect to FD and FC stock to their respective postdistribution amounts. Under paragraph (e)(1) of this section, USS1's predistribution amount with respect to FD or FC is USS1's section 1248 amount computed immediately before the distribution, but only to the extent such amount is attributable to FD or FC. USS2's predistribution amount is determined in the same manner. Under § 1.367(b)–2(c)(1), USS1 and USS2 each have a section 1248 amount computed immediately before the distribution of $250, all of which is attributable to FC. Thus, USS1 and USS2 each have a predistribution amount with respect to FD of $0, and each have a predistribution amount with respect to FC of $250. These amounts are computed as follows: If either USS1 or USS2 had sold its FD stock immediately before the transaction, it would have recognized $250 of gain ($750 fair market value—$500 basis). All of the gain would have been treated as a dividend under section 1248, and all of the section 1248 amount would have been attributable to FC (based on USS1's and USS2's pro rata shares of FC's earnings and profits (50 percent x $500)).

(B) Under paragraph (d)(3) of this section, a distributee that owns no stock in the distributing or controlled corporation immediately after the distribution has a postdistribution amount with regard to that stock of zero. Accordingly, USS2 has a postdistribution amount of $0 with respect to FD and USS1 has a postdistribution amount of $0 with respect to FC. Under paragraph (e)(2) of this section, USS1's postdistribution amount with respect to FD is its section 1248 amount with respect to such corporation, computed immediately after the distribution (but without regard to paragraph (d) of this section). USS2's postdistribution amount with respect to FC is determined in the same manner. Under § 1.367(b)–2(c)(1), USS1's section 1248 amount computed immediately after the distribution with respect to FD is $0 and USS2's section 1248 amount computed immediately after the distribution with respect to FC is $250. These amounts, which are USS1's and USS2's postdistribution amounts, are computed as follows: After the non-pro rata distribution, USS1 owns all the stock of FD and USS2 owns all the stock of FC. If USS1 sold its FD stock immediately after the distribution, none of the resulting $250 gain ($750 fair market value $500 basis) would be treated as a dividend under section 1248. If USS2 sold its FC stock immediately after the distribution, it would have a $250 gain ($750 fair market value—$500 basis), all of which would be treated as a dividend under section 1248.

(C) The income inclusion rule of paragraph (d)(3) of this section applies to the extent of any difference between USS1's and USS2's postdistribution and predistribution amounts. In the case of USS2, there is no difference between the two amounts with respect to either FD or FC and, as a result, no income inclusion is required. In the case of USS1, there is no difference between the two amounts with respect to its FD stock. However, USS1's postdistribution amount with respect to FC is $250 less than its predistribution amount. Accordingly, under paragraph (d)(3) of this section, USS1 is required to include $250 in income as a deemed dividend. Under § 1.367(b)–2(e)(2), the $250 deemed dividend is considered as having been paid by FC to FD, and by FD to USS1, immediately prior to the distribution. This deemed dividend increases USS1's basis in FD ($500 + $250 = $750).

§ 1.367(b)–6 Effective dates and coordination rules.

(a) *Effective date*—(1) *In general.* Sections 1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur on or after February 23, 2000.

(2) *Exception.* A taxpayer may, however, elect to have §§ 1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur (or occurred) before February 23, 2000, if the due date for the taxpayer's timely filed Federal tax return (including extensions) for the taxable year in which the section 367(b) exchange occurs (or occurred) is after February 23, 2000. The election under this paragraph (a)(2) will be valid only if—

(i) The electing taxpayer makes the election on a timely filed section 367(b) notice;

(ii) In the case of an exchanging shareholder that is a foreign corporation, the election is made on the section 367(b) notice that is filed by each of its shareholders listed in § 1.367(b)–1(c)(3)(ii); and

(iii) The electing taxpayer provides notice of the election to all corporations (or their successors in interest) whose earnings and profits are affected by the election on or before the date the section 367(b) notice is filed.

(b) *Certain recapitalizations described in § 1.367(b)–4(b)(3).* In the case of a recapitalization described in § 1.367(b)–4(b)(3) that occurred prior to July 20, 1998, the exchanging shareholder shall include the section 1248 amount on its tax return for the taxable year that includes the exchange described in § 1.367(b)–4(b)(3)(i) (and not in the taxable year of the recapitalization), except that no inclusion is required if both the recapitalization and the exchange described in § 1.367(b)–4(b)(3)(i) occurred prior to July 20, 1998.

(c) *Use of reasonable method to comply with prior published guidance*—

(1) *Prior exchanges.* The taxpayer may use a reasonable method to comply with the following prior published guidance to the extent such guidance relates to section 367(b): Notice 88–71 (1988–2 C.B. 374); Notice 89–30 (1989–1 C.B. 670); and Notice 89–79 (1989–2 C.B. 392) (see § 601.601(d)(2) of this chapter). This rule applies to section 367(b) exchanges that occur (or occurred) before February 23, 2000, or, if a taxpayer makes the election described in paragraph (a)(2) of this section, for section 367(b) exchanges that occur (or occurred) before the date described in paragraph (a)(2) of this section. This rule also applies to section 367(b) exchanges and distributions described in paragraph (d) of this section.

(2) *Future exchanges.* Section 367(b) exchanges that occur on or after February 23, 2000, (or, if a taxpayer makes the election described in paragraph (a)(2) of this section, for section 367(b) exchanges that occur on or after the date described in paragraph (a)(2) of this section) are governed by the section 367(b) regulations and, as a result, paragraph (c)(1) of this section shall not apply.

(d) *Effect of removal of attribution rules.* To the extent that the rules under §§ 7.367(b)–9 and 7.367(b)–10(h) of this chapter, as in effect prior to February 23, 2000 (see 26 CFR part 1, revised as of April 1, 1999), attributed earnings and profits to the stock of a foreign corporation in connection with an exchange described in section 351, 354, 355, or 356 before February 23, 2000, the foreign corporation shall continue to be subject to the rules of § 7.367(b)–12 of this chapter in the event of any subsequent exchanges and distributions with respect to such stock, notwithstanding the fact that such subsequent exchange or distribution occurs on or after the effective date described in paragraph (a) of this section.

§§ 1.367(b)–7 through 1.367(b)–9 [Removed]

Par. 8. Sections 1.367(b)–7 through 1.367(b)–9 are removed.

Par. 9. Section 1.381(b)–1, paragraph (a)(1), the second sentence is amended by removing the reference ''7.367(b)–1(e)'' and adding ''1.367(b)–2(f)'' in its place.

PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Par. 10. The authority citation for part 7 is amended by removing the entries for §§ 7.367(b)–1, 7.367(b)–2, 7.367(b)–3, 7.367(b)–4, 7.367(b)–5, 7.367(b)–6, 7.367(b)–7, 7.367(b)–8, 7.367(b)–9, 7.367(b)–10, 7.367(b)–11, and 7.367(b)–13; and continues to read in part as follows:

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

Par. 11. Sections 7.367(b)–1 through 7.367(b)–11 and 7.367(b)–13 are removed as of February 23, 2000.

Par. 12. Section 7.367(b)–12 is amended by revising paragraph (a) to read as follows:

§ 7.367(b)–12 Subsequent treatment of amounts attributed or included in income (temporary).

(a) *Application.* This section applies to distributions with respect to, or a disposition of, stock—

(1) To which, in connection with an exchange occurring before February 23, 2000, an amount has been attributed pursuant to § 7.367(b)–9 or 7.367(b)–10 (as in effect prior to February 23, 2000; see 26 CFR Part 1 revised as of April 1, 1999); or

(2) In respect of which, before February 23, 2000, an amount has been included in income or added to earnings and profits pursuant to § 7.367(b)–7 or 7.367(b)–10 (as in effect prior to February 23, 2000); see 26 CFR Part 1 revised as of April 1, 1999).

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PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 13. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. In § 602.101, paragraph (b) is amended in the table by adding an entry in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * *	* *
1.367(b)–1	1545–1271
* * *	* *

John M. Dalrymple,

Acting Deputy Commissioner of Internal Revenue.

Approved: December 22, 1999.

Jonathan Talisman,

Acting Assistant Secretary of the Treasury.

[FR Doc. 00–1377 Filed 1–21–00; 8:45 am]

BILLING CODE 4830–01–U

POSTAL SERVICE

39 CFR Part 111

Barcode Requirements for Special Services Labels

AGENCY: Postal Service.

ACTION: Final rule.

SUMMARY: The Postal Service has redesigned the following special services forms and labels: PS Form 3800, Receipt for Certified Mail; PS Form 3813–P, Receipt for Insured Mail—Domestic—International; PS Form 8099, Receipt for Recorded Delivery; Label 200, Registered Mail; and PS Form 3804, Return Receipt for Merchandise. In addition to the current Optical Character Reader font on the labels, the Postal Service is placing formatted barcodes. The USS–128 Subset A format barcode will be used on all USPS-printed retail labels for insured mail, recorded delivery mail, and registered mail. The USS Code 128 Subset C format will be used on all USPS-printed retail labels for certified mail and return receipt for merchandise. Customer-generated labels for these services will be either USS Code 128 or USS I 2 of 5 barcode format. Vendors and mailers preparing customer-generated labels will be required to comply with these requirements for special service labels by June 10, 2000. This final rule sets forth the new Domestic Mail Manual (DMM) and International Mail Manual (IMM) language.

DATES: Effective January 24, 2000. All parties must comply with this final rule by June 10, 2000.

FOR FURTHER INFORMATION CONTACT: Mary Shriver, (202) 268–6554.

SUPPLEMENTARY INFORMATION: On October 6, 1999, the Postal Service published in the **Federal Register** a proposed rule seeking public comment on a proposal to require barcodes on special services labels. The Postal Service received responses from mailers offering comments, but only on the technical specifications in the proposed rule. Five comments were submitted on label dimensions and sizes, four concerned printing specifics, two expressed uncertainty about the required label stock, nine inquired on barcode specifics, and three sought clarification of compliance procedures. In order to address the highly specific nature of comments received regarding the technical specifications of barcodes for the new special services labels, the Postal Service is responding to each respondent's comments or concerns individually by letter.