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## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9761]

RIN 1545-BM88

Inversions and Related Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that address transactions that are structured to avoid the purposes of sections 7874 and 367 of the Internal Revenue Code (the Code) and certain post-inversion tax avoidance transactions. These regulations affect certain domestic corporations and domestic partnerships whose assets are directly or indirectly acquired by a foreign corporation and certain persons related to such domestic corporations and domestic partnerships. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**. The final regulations revise and add cross-references to coordinate the application of the temporary regulations.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.304-7T(e), 1.367(a)-3T(c)(11)(ii), 1.367(b)-4T(h), 1.956-2T(i), 1.7701(l)-4T(h), 1.7874-1T(h)(2), 1.7874-

2T(l)(2), 1.7874-3T(f)(2), 1.7874-4T(k)(1), 1.7874-6T(h), 1.7874-7T(h), 1.7874-8T(i), 1.7874-9T(g), 1.7874-10T(i), 1.7874-11T(f), and 1.7874-12T(b).

FOR FURTHER INFORMATION CONTACT: Regarding the regulations under sections 304, 367, and 7874, Shane M. McCarrick or David A. Levine, (202) 317-6937; regarding the regulations under sections 956 and 7701(l), Rose E. Jenkins, (202) 317-6934 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

## **Background**

### **I. Overview**

This document contains regulations to address transactions commonly referred to as inversions and certain tax avoidance transactions related to inversions. An inversion may take many forms but has been generally described as a transaction that results in a domestic parent corporation of a multinational group being replaced with a foreign parent corporation. Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 31, 2005) (the JCT Explanation), at 342. An inversion is typically accompanied or followed by certain transactions that are intended “to remove income from foreign operations from the U.S. taxing jurisdiction.” *Id.* In addition, the “corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions.” *Id.*

Section 7874 and the regulations thereunder and §1.367(a)-3(c) (concerning outbound transfers of domestic stock) are intended to address inversions. As described in Part II.F of this Background section, section 7874 generally applies to a transaction if

three conditions are satisfied. When these conditions are satisfied, section 7874 either prevents the use of certain tax attributes to reduce the U.S. federal income tax owed on certain income or gain (inversion gain) recognized in transactions intended to remove foreign operations from the U.S. taxing jurisdiction, or treats the new foreign parent corporation as a domestic corporation for all purposes of the Code. As described in Part II.B.1 of this Background section, in certain inversions, §1.367(a)-3(c) causes a United States person that is a shareholder of the domestic parent corporation to recognize gain (but not loss) on the exchange of its stock in the domestic corporation.

On September 22, 2014, the Department of the Treasury (Treasury Department) and the IRS issued Notice 2014-52, 2014-42 I.R.B. 712 (the 2014 notice), which announced the intention to issue regulations described therein to address certain transactions structured to avoid the purposes of section 7874 and §1.367(a)-3(c) and certain post-inversion tax avoidance transactions. On November 19, 2015, the Treasury Department and the IRS issued Notice 2015-79, 2015-49 I.R.B. 775 (the 2015 notice), which announced the intention to issue regulations described therein to address certain additional transactions structured to avoid the purposes of section 7874 and §1.367(a)-3(c) and certain additional post-inversion tax avoidance transactions. This document contains temporary regulations under sections 304, 367, 956, 7701(l), and 7874 of the Code.

The temporary regulations include the rules described in the two notices. Part I of the Explanation of Provisions section of this preamble explains the regulations addressing certain transactions structured to avoid the purposes of section 7874. Part II of the Explanation of Provisions section of this preamble explains the regulations

addressing certain post-inversion tax avoidance transactions. In addition, the temporary regulations set forth new rules that address issues that were not discussed in either notice: (i) rules for identifying a foreign acquiring corporation when a domestic entity acquisition involves multiple steps (described in Part I.A of the Explanation of Provisions section of this preamble); (ii) rules that disregard stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions (described in Part I.B.3 of the Explanation of Provisions section of this preamble); (iii) rules that require a controlled foreign corporation (CFC) to recognize all realized gain upon certain transfers of assets described in section 351 that shift the ownership of those assets to a related foreign person that is not a CFC (described in Part II.B.3 of the Explanation of Provisions section of this preamble); and (iv) rules clarifying the definition of group income for purposes of the substantial business activities test (described in Part I.D.2 of the Explanation of Provisions section of this preamble). The temporary regulations also contain the rules described in Notice 88-108, 1988-2 C.B. 445; Notice 2008-91, 2008-43 I.R.B. 1001; Notice 2009-10, 2009-5 I.R.B. 419; and Notice 2010-12, 2010-4 I.R.B. 326, concerning the short-term obligation exception from United States property for purposes of section 956.

In addition, the temporary regulations provide a new definitions section under §1.7874-12T that defines terms commonly used in certain of the regulations under sections 367(b), 956, 7701(l), and 7874. It is expected that future guidance projects will conform the nomenclature used in other portions of the existing section 7874 regulations with the nomenclature used in §1.7874-12T.

The applicability dates for the rules that previously were announced in the 2014 notice and the 2015 notice are consistent with the dates previously announced. Thus, the rules described in the 2014 notice that address transactions that are structured to avoid the purposes of section 7874 apply to acquisitions completed on or after September 22, 2014, and the rules described in the 2015 notice that address transactions that are structured to avoid the purposes of section 7874 apply to acquisitions completed on or after November 19, 2015. Furthermore, the rules described in the 2014 notice that reduce the tax benefits of inversion transactions apply to post-inversion tax avoidance transactions completed on or after September 22, 2014, and the rules described in the 2015 notice that reduce the tax benefits of inversion transactions apply to post-inversion tax avoidance transactions completed on or after November 19, 2015. In both cases described in the preceding sentence, subject to one exception, the rules apply only if the inversion transaction was completed on or after September 22, 2014. The one exception is that, consistent with the 2014 notice, the rule described in Part II.B.4 of the Explanation of Provisions section of this preamble regarding the application of section 304(b)(5) is a generally applicable rule that applies without regard to whether there was an inversion transaction.

The new rules included in the temporary regulations, including any changes to rules described in the 2014 notice and the 2015 notice, generally apply to acquisitions or post-inversion tax avoidance transactions completed on or after **April 4, 2016**. In addition, and consistent with the announcement in the 2014 notice, the new rule described in Part II.B.3 of the Explanation of Provisions section of this preamble that reduces post-inversion tax benefits (by requiring a CFC to recognize all realized gain

upon certain section 351 transfers) applies only if the inversion transaction was completed on or after September 22, 2014. However, no inference is intended as to the treatment of transactions described in the temporary regulations and this preamble under the law that applied before the applicability date of these regulations. The IRS may, where appropriate, challenge transactions, including those described in the temporary regulations and this preamble, under applicable Code or regulatory provisions or judicial doctrines.

Comments were received on the 2014 notice. One comment was received on the 2015 notice, but the comment was received after these temporary regulations had been substantially developed such that the Treasury Department and the IRS did not have time to fully consider the comment. The Treasury Department and the IRS will include this comment in the administrative record for the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register** (REG-135734-14) and fully consider the comment in connection with finalization of the proposed regulations.

## II. Statutory and Regulatory Background

### A. Section 304

Section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and, in return for property, one of the corporations (acquiring corporation) acquires stock in the other corporation (issuing corporation) from the person (or persons) so in control, then (unless section 304(a)(2) applies) the property shall be treated as a distribution in redemption of the stock of the acquiring corporation.

Section 304(a)(2) provides that, for purposes of sections 302 and 303, if in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and the issuing corporation controls the acquiring corporation, then the property shall be treated as a distribution in redemption of the stock of the issuing corporation.

Section 304(b)(2) provides that, in the case of any acquisition to which section 304(a) applies, the determination of the amount that is a dividend (and the source thereof) shall be made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

Section 304(b)(5)(B) limits the earnings and profits taken into account under section 304(b)(2) when the acquiring corporation is foreign. Specifically, section 304(b)(5)(B) provides that no earnings and profits are taken into account for purposes of section 304(b)(2)(A) (and section 304(b)(2)(A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to section 304(b)(5)(B)) would neither be subject to U.S. federal income tax for the taxable year in which the dividends arise, nor be included in the earnings and profits of a CFC.

The Staff of the Joint Committee on Taxation's technical explanation of section 304(b)(5)(B) provides:

The provision prevents the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation.

Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010 (JCX-46-10) (August 10, 2010), at 28.

Section 304(b)(5)(C) provides that the Secretary shall prescribe such regulations as are necessary to carry out the purposes of section 304(b)(5).

**B. Section 367**

**1. Section 367(a)**

Subject to certain exceptions, section 367(a)(1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on the transfer. Section 1.367(a)-3(c) provides an exception to the general rule of section 367(a)(1) for certain transfers by a United States person of stock or securities of a domestic corporation (the U.S. target company) to a foreign corporation. This exception only applies, however, if the U.S. target company complies with the reporting requirements in §1.367(a)-3(c)(6) and if the four conditions set forth in §1.367(a)-3(c)(1)(i) through (iv) are satisfied. The condition set forth in §1.367(a)-3(c)(1)(iv) requires the active trade or business test (as defined in §1.367(a)-3(c)(3)) to be satisfied, the requirements of which include the substantiality test (as defined in §1.367(a)-3(c)(3)(iii)). The substantiality test is satisfied if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company. For this purpose, the fair market value



of the transferee foreign corporation generally does not include assets acquired outside the ordinary course of business within the 36-month period preceding the exchange if they produce, or are held for the production of, passive income or are acquired for the principal purpose of satisfying the substantiality test.

## 2. Section 367(b)

Section 367(b)(1) provides that, in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary that are necessary or appropriate to prevent the avoidance of U.S. federal income taxes.

Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) 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 United States person, including regulations providing the circumstances under which gain is recognized or deferred, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to the basis of stock or securities.

Regulations under section 367(b) generally provide that, if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation (foreign acquired corporation) by another foreign corporation in an exchange subject to section 367(b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount attributable to the stock of the foreign acquired corporation exchanged. See §1.367(b)-4(b). Under §1.367(b)-2(c)(1), the section 1248 amount

attributable to the stock of a foreign acquired 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 if the stock were sold by the exchanging shareholder.

Specifically, subject to certain exceptions, §1.367(b)-4(b)(1)(i) requires a deemed dividend inclusion if the exchange satisfies two conditions. First, immediately before the exchange, the exchanging shareholder is either (i) a United States person that is a section 1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation, and a United States person is a section 1248 shareholder with respect to such foreign corporation and the foreign acquired corporation. See §1.367(b)-4(b)(1)(i)(A). Second, immediately after the exchange, either (i) the stock received by the exchanging shareholder is not stock in a CFC as to which the United States person described in the preceding sentence is a section 1248 shareholder, or (ii) the foreign acquiring corporation (for this purpose, as defined in §1.367(b)-4(a)) or the foreign acquired corporation (in the case of an acquisition of the stock of the foreign acquired corporation) is not a CFC as to which the United States person is a section 1248 shareholder. See §1.367(b)-4(b)(1)(i)(B).

Section 1.367(b)-4(c)(1) provides that a section 1248 amount included in income as a deemed dividend under §1.367(b)-4(b) is not included as foreign personal holding company income (FPHCI) under section 954(c).

#### C. Section 954

Section 954 defines foreign base company income (FBCI), which generally is income earned by a CFC that is taken into account in computing the amount that a

United States shareholder (within the meaning of section 951(b)) of the CFC must include in income under section 951(a)(1)(A). FBCI includes FPHCI, as defined in section 954(c), which, in turn, generally includes dividends. Section 954(c)(1)(A). However, dividends generally are excluded from FPHCI if they are received from a related person that (i) is a corporation created or organized under the laws of the same foreign country under the laws of which the CFC is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in that foreign country. Section 954(c)(3).

In addition, for certain taxable years, dividends received or accrued from another CFC that is a related person generally are excluded from the FPHCI of a CFC to the extent the dividends are attributable or properly allocable to income of the related person that is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States. Section 954(c)(6). Section 103(b)(1) of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222, 120 Stat. 345) added section 954(c)(6), which applied to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which these taxable years of the foreign corporation ended. Subsequently, section 954(c)(6) was amended five times to extend its applicability. Section 304(a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Public Law 110-343, 122 Stat. 3765); section 751(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, 124 Stat. 3296); section 323(a) of the American Taxpayer Relief Act of 2012 (Public Law 112-240, 126 Stat. 2313); section

135(a) of Tax Increase Prevention Act of 2014 (Public Law 113-295, 128 Stat. 4010); and section 144 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114-113, 129 Stat. 2242). Currently, section 954(c)(6) applies to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2020, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end. Section 954(c)(6)(A) provides the Secretary with the authority to prescribe regulations as may be necessary or appropriate to carry out section 954(c)(6), including regulations as may be necessary or appropriate to prevent the abuse of its purposes.

D. Section 956

Section 956 determines the amount that a United States shareholder of a CFC must include in gross income with respect to the CFC under section 951(a)(1)(B). This amount is determined, in part, based on the average amount of United States property held, directly or indirectly, by the CFC at the close of each quarter during its taxable year. Subject to certain exceptions, section 956(c) generally defines United States property to include stock and obligations of United States persons that are related to the CFC. Sections 956(c)(1)(B) and (C) and 956(c)(2)(F) and (L). The term “obligation” is defined in §1.956-2T(d). Section 956(e) grants the Secretary authority to prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956 through reorganizations or otherwise. In addition, section 956(d) grants the Secretary authority to prescribe regulations pursuant to which a CFC that is a pledgor or guarantor of an obligation of a United States person is considered to hold the obligation. Section 1.956-2(c) provides

that a CFC that is a direct or indirect pledgor or guarantor of an obligation of a United States person is treated as holding the obligation. Section 3.01(a) of the 2014 notice discusses relevant legislative history of section 956.

E. Section 7701

Section 7701(l) grants the Secretary authority to issue regulations re-characterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such re-characterization is appropriate to prevent avoidance of any tax imposed under the Code. Section 3.02(a) of the 2014 notice discusses relevant legislative history of section 7701(l).

F. Section 7874

Under section 7874, a foreign corporation (foreign acquiring corporation) generally is treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions) three conditions are satisfied. First, the foreign acquiring corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (domestic entity acquisition). Second, after the domestic entity acquisition, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation (former domestic entity shareholders) by reason of holding stock in the domestic corporation (such percentage is referred to at times in this preamble as the “ownership percentage,” and, the fraction used to calculate the ownership percentage is referred to at times in this preamble as the “ownership fraction”). And third, after the domestic entity acquisition,

the expanded affiliated group (as defined in section 7874(c)(1)) that includes the foreign acquiring corporation (EAG) does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized (relevant foreign country), when compared to the total business activities of the EAG. Pursuant to section 7874(c)(1), an EAG is an affiliated group defined in section 1504(a), but without regard to the exclusion of foreign corporations in section 1504(b)(3) and using a more-than-50-percent ownership threshold in lieu of the 80-percent ownership threshold in section 1504(a). Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership. The domestic corporation or the domestic partnership described in this paragraph is referred to at times in this preamble as the “domestic entity.”

The tax treatment of a domestic entity acquisition in which the EAG does not have substantial business activities in the relevant foreign country varies depending on the level of owner continuity. If the ownership percentage is at least 80, the foreign acquiring corporation is treated as a domestic corporation for all purposes of the Code pursuant to section 7874(b). If, instead, the ownership percentage is at least 60 but less than 80 (in which case the domestic entity acquisition is referred to in this preamble as an “inversion transaction”), the foreign acquiring corporation is respected as a foreign corporation, but, under section 7874(a)(1), the taxable income of the domestic entity and certain related United States persons (referred to as “expatriated entities” and defined in section 7874(a)(2)(A)) for any year that includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year.

Section 7874(d)(1) defines the term “applicable period” as the period beginning on the first date properties are acquired as part of the domestic entity acquisition, and ending on the date that is 10 years after the last date properties are acquired as part of the domestic entity acquisition. In addition, section 7874(d)(2) generally provides that the term “inversion gain” means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity, provided the transfer or license takes place as part of the domestic entity acquisition or, under subparagraph (B), after the domestic entity acquisition if the transfer or license is to a foreign related person. Section 7874(d)(2) provides that subparagraph (B) does not apply to property described in section 1221(a)(1) (generally, property that is inventory) in the hands of the expatriated entity.

Section 7874(d)(3) provides that the term “foreign related person” means, with respect to any expatriated entity, a foreign person that is (i) related (within the meaning of section 267(b) or 707(b)(1)) to the entity, or (ii) under the same common control (within the meaning of section 482) as the entity.

Section 7874(e)(2)(A) provides that, in the case of an expatriated entity that is a partnership, section 7874(a)(1) shall apply at the partner rather than the partnership level.

Under section 7874(c)(4), a transfer of properties or liabilities (including by contribution or distribution) is disregarded if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. In addition, section

7874(c)(6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock. Finally, section 7874(g) grants the Secretary authority to provide regulations necessary to carry out section 7874, including regulations providing for such adjustments to the application of section 7874 as are necessary to prevent the avoidance of the purposes of section 7874, including the avoidance of such purposes through (i) the use of related persons, pass-through or other non-corporate entities, or other intermediaries, or (ii) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.

## **Explanation of Provisions**

### **I. Regulations Addressing Certain Transactions that Are Structured to Avoid the Purposes of Section 7874**

This Part I describes rules for (i) identifying domestic entity acquisitions and foreign acquiring corporations in certain multiple-step transactions; (ii) calculating the ownership percentage and, more specifically, disregarding certain stock of the foreign acquiring corporation for purposes of computing the denominator of the ownership fraction and, in addition, taking into account certain non-ordinary course distributions (NOCDs) made by a domestic entity for purposes of computing the numerator of the ownership fraction; (iii) determining when certain stock of a foreign acquiring corporation is treated as held by a member of the EAG; and (iv) determining when an EAG has substantial business activities in a relevant foreign country.

#### **A. Multiple-step acquisition of property of a domestic entity**

##### **1. Background**



Section 1.7874-2(c) provides guidance on the types of transactions that constitute a direct or indirect acquisition by a foreign corporation of properties held directly or indirectly by a domestic entity and that therefore potentially result in a domestic entity acquisition. Section 1.7874-2(c)(1) sets forth a non-exclusive list of the types of transactions that generally result in an indirect acquisition of properties of a domestic entity. In addition, §1.7874-2(c)(2) provides that when a foreign corporation acquires stock of another foreign corporation, which, in turn, directly or indirectly owns stock or a partnership interest in a domestic entity, the acquisition by the foreign corporation does not constitute an indirect acquisition of any properties held by the domestic entity. Absent §1.7874-2(c)(2), the foreign corporation's acquisition of the stock of the other foreign corporation would be an indirect acquisition of properties of the domestic entity. However, because the domestic entity had a foreign parent before the acquisition, these types of transactions typically do not give rise to the policy concerns that motivated Congress to enact section 7874, and therefore they generally are not treated as indirect acquisitions of properties of a domestic entity. This rule does not, however, address multiple related acquisitions of the properties of a domestic entity.

Section 1.7874-2(f) provides a non-exclusive list of stock of a foreign corporation that is described in section 7874(a)(2)(B)(ii) (that is, stock of the foreign acquiring corporation held by former domestic entity shareholders or former domestic entity partners by reason of holding stock or partnership interests in the domestic entity; at times, referred to in this preamble as "by-reason-of stock").

## 2. Transactions at Issue

The Treasury Department and the IRS are concerned that taxpayers may take the position that certain transactions are not domestic entity acquisitions even though the transactions give rise to the policy concerns that motivated Congress to enact section 7874. This could occur, for example, when a foreign corporation (initial acquiring corporation) acquires substantially all of the properties held by a domestic entity (the initial acquisition) in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under section 7874(b) (for example, because the ownership percentage is less than 80 or because the EAG purports to meet the substantial business activities exception in §1.7874-3), and, pursuant to a plan that includes the initial acquisition (or a series of related transactions), another foreign corporation (subsequent acquiring corporation) acquires substantially all of the properties of the initial acquiring corporation (the subsequent acquisition). In these cases, a taxpayer may take the position that the form of the transactions is respected for U.S. federal income tax purposes and that §1.7874-2(c)(2) prevents the subsequent acquiring corporation from being considered to have indirectly acquired the properties of the domestic entity pursuant to the subsequent acquisition. Under this position, although the initial acquisition would be a domestic entity acquisition and the initial acquiring corporation would be a foreign acquiring corporation, the subsequent acquisition would not be a domestic entity acquisition, and the subsequent acquiring corporation would not be a foreign acquiring corporation. Moreover, for purposes of computing the ownership percentage, a taxpayer may assert that former domestic entity shareholders do not hold stock of the subsequent acquiring corporation by reason of

holding stock in the domestic entity and, instead, hold stock of the subsequent acquiring corporation only by reason of holding stock in the initial acquiring corporation.

In certain cases, these positions are contrary to the purposes of section 7874, including the purposes of (i) the third-country rule set forth in §1.7874-9T (and described in Section B.4 of this Part I), if the subsequent acquiring corporation and the initial acquiring corporation are subject to tax as residents of different foreign countries, or (ii) the substantial business activities exception in §1.7874-3 if the EAG has substantial business activities in the foreign country in which, or under the laws of which, the initial acquiring corporation is created or organized but does not have substantial business activities in the foreign country in which, or under the laws of which, the subsequent acquiring corporation is created or organized.

### 3. Multiple-Step Acquisition Rule

To address the concerns described in Section 2 of this Part I.A, the temporary regulations provide a rule (the multiple-step acquisition rule) that treats the subsequent acquisition as a domestic entity acquisition and the subsequent acquiring corporation as a foreign acquiring corporation. §1.7874-2T(c)(4)(i). When the multiple-step acquisition rule applies, the temporary regulations treat stock of the subsequent acquiring corporation received, pursuant to the subsequent acquisition, in exchange for stock of the initial acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, stock of the initial acquiring corporation that, as a result of the initial acquisition, is by-reason-of stock) as stock of the subsequent acquiring corporation held by reason of holding stock in the domestic entity. §1.7874-2T(f)(1)(iv).

Further, if, pursuant to the same plan (or a series of related transactions), a foreign corporation directly or indirectly acquires substantially all of the properties held by a subsequent acquiring corporation in a transaction that occurs after the subsequent acquisition, the principles of the multiple-step acquisition rule apply to also treat the further acquisition as a domestic entity acquisition and the foreign corporation that made such acquisition as a foreign acquiring corporation. §1.7874-2T(c)(4)(iii). For example, if, pursuant to a plan, a foreign corporation (F1) acquires substantially all of the properties held by a domestic corporation, followed by another foreign corporation (F2) acquiring substantially all of the properties held by F1, followed, in turn, by another foreign corporation (F3) acquiring substantially all of the properties held by F2, then the multiple-step acquisition rule also would treat F3's acquisition of F2's properties as a domestic entity acquisition and F3 as a foreign acquiring corporation. In such a case, the principles of the multiple-step acquisition rule would apply in a similar manner to treat stock of F3 as by-reason-of stock to the extent the F3 stock is received in exchange for F2 stock that is itself treated as by-reason-of stock under the multiple-step acquisition rule.

The multiple-step acquisition rule applies in a similar manner when the domestic entity is a domestic partnership.

These rules do not affect the application of section 7874 to the initial acquisition. As a result, section 7874 may apply to both the initial acquisition and the subsequent acquisition. In addition, and like other guidance under §1.7874-2, the multiple-step acquisition rule applies solely for section 7874 purposes. Accordingly, this rule does not

modify general tax principles (such as the step-transaction doctrine) or other rules or guidance that may apply to related transactions.

B. Calculation of the ownership percentage

1. Clarification of §1.7874-4T

a. §1.7874-4T, in general

Under section 7874(c)(2)(B) (statutory public offering rule), stock of a foreign acquiring corporation that is sold in a public offering related to a domestic entity acquisition described in section 7874(a)(2)(B)(i) is excluded from the denominator of the ownership fraction. The statutory public offering rule furthers the policy that section 7874 is intended to curtail domestic entity acquisitions that “permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion.” S. Rep. No. 192, 108th Cong., 1st. Sess., at 142 (2003); JCT Explanation, at 343.

Section 1.7874-4T modifies the statutory public offering rule. The preamble to §1.7874-4T provides that “the IRS and the Treasury Department believe that stock of the foreign acquiring corporation transferred in exchange for certain property in a transaction related to the acquisition, but not through a public offering, presents the same opportunity to inappropriately reduce the ownership fraction.” TD 9654, published on January 17, 2014, in the **Federal Register** (79 FR 3094, at 3095). Accordingly, §1.7874-4T(b) provides that, subject to a de minimis exception, “disqualified stock” is not included in the denominator of the ownership fraction. Disqualified stock generally includes stock of the foreign acquiring corporation that is transferred to a person (other than the domestic entity) in exchange for “nonqualified property.” The term

“nonqualified property” means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations (for example, obligations owed by members of the EAG), or (iv) any other property acquired in a transaction (or series of transactions) related to the domestic entity acquisition with a principal purpose of avoiding the purposes of section 7874. This preamble refers at times to the property described in clauses (i), (ii), and (iii) of the preceding sentence collectively as “specified nonqualified property” and to the property described in clause (iv) as “avoidance property.” For this purpose, the term “marketable securities” has the meaning set forth in section 453(f)(2), except that the term does not include stock of a corporation or an interest in a partnership that becomes a member of the EAG in a transaction (or series of transactions) related to the domestic entity acquisition, unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of section 7874.

b. Clarification

Section 2.03(b) of the 2015 notice provides that §1.7874-4T will be clarified in certain respects. The temporary regulations implement these clarifications. Accordingly, with respect to the definition of nonqualified property, the temporary regulations clarify that avoidance property means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of specified nonqualified property. See §1.7874-4T(j), Example 3. Second, the temporary regulations remove the phrase “in a transaction (or series of transactions) related to the acquisition” from the definition of avoidance property. See §1.7874-4T(i)(7)(iv). Third, the temporary regulations remove the phrase “unless a principal purpose for acquiring

such stock or partnership interest is to avoid the purposes of section 7874” from the definition of “marketable securities.” See §1.7874-4T(i)(6). Finally, the temporary regulations clarify Example 1 and Example 2 of §1.7874-4T(j) by including a reference to section 7874(c)(4).

In addition, the temporary regulations update the de minimis exception in §1.7874-4T(d)(1) to reflect the passive assets rule (described in Section 2 of this Part I.B) and the NOCD rule (described in Section 5 of this Part I.B), and to also conform the exception to the de minimis exceptions in §§1.7874-7T(c) and 1.7874-10T(d).

## 2. Passive Assets Rule

### a. Overview of the 2014 notice

Section 2.01(b) of the 2014 notice announced that future regulations would include a rule (the passive assets rule) that would exclude from the denominator of the ownership fraction stock of a foreign acquiring corporation that is attributable to certain passive assets, but only if, after the domestic entity acquisition and all related transactions are complete, more than 50 percent of the gross value of all foreign group property constitutes certain passive assets (referred to in the notice and temporary regulations as “foreign group nonqualified property”). See Section b of this Part I.B.2 for the definition of foreign group property and foreign group nonqualified property. The temporary regulations implement the passive assets rule described in the 2014 notice, subject to the modifications described in Section c of this Part I.B.2.

The 2014 notice provides that the amount of stock that will be excluded under the passive assets rule is equal to the product of (i) the value of the stock of the foreign acquiring corporation, other than stock that is described in section 7874(a)(2)(B)(ii) (that

is, by-reason-of stock) and stock that is excluded from the denominator of the ownership fraction under either §1.7874-1(b) (because it is held by a member of the EAG) or §1.7874-4T(b) (because it is disqualified stock); and (ii) the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is the gross value of all foreign group nonqualified property, and the denominator is the gross value of all foreign group property. However, property received by the foreign acquiring corporation that gives rise to stock that is excluded from the ownership fraction under §1.7874-4T(b) is excluded from both the numerator and the denominator of the foreign group nonqualified property fraction, as applicable.

In addition, the 2014 notice provides that the passive assets rule will incorporate the principles of §1.7874-4T(h) (regarding the interaction of the EAG rules with the rule that excludes disqualified stock from the denominator of the ownership fraction) with respect to stock of the foreign acquiring corporation that is excluded under the passive assets rule.

b. Foreign group property and foreign group nonqualified property

The 2014 notice provides that foreign group property means any property (including property that gives rise to disqualified stock upon application of §1.7874-4T) held by the EAG after the domestic entity acquisition and all transactions related to that acquisition are complete, other than the following property: (i) property that is directly or indirectly acquired in the domestic entity acquisition and that, at the time of the domestic entity acquisition, was held directly or indirectly by the domestic entity; and (ii) to avoid double counting, stock or a partnership interest in a member of the EAG and an



obligation described in §1.7874-4T(i)(7)(iii)(A) (that is, an obligation of a member of the EAG).

With respect to foreign group nonqualified property, the 2014 notice provides that the term generally means foreign group property that is described in §1.7874-4T(i)(7) other than property that gives rise to income described in section 1297(b)(2)(A) (the banking exception under the passive foreign investment company (PFIC) rules) or section 954(h) or (i) (subpart F exceptions for qualified banking or financing income and for qualified insurance income, respectively), determined by substituting the term “foreign corporation” for the term “controlled foreign corporation.” In addition, a special rule treats certain property (referred to as “substitute property”) that would not be foreign group nonqualified property under the general rule as foreign group nonqualified property if, in a transaction related to the acquisition, such property is acquired in exchange for other property that would be foreign group nonqualified property under the general rule.

Section 4.01(b)(i) of the 2015 notice modifies the general definition of foreign group nonqualified property to also exclude from that definition property that gives rise to income described in section 1297(b)(2)(B) (the PFIC insurance exception). Further, section 4.01(b)(ii) of the 2015 notice provides that the general definition of foreign group nonqualified property does not include property (i) held by a domestic corporation that is subject to tax as an insurance company under subchapter L, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business; or (ii) that gives rise to income described in section 954(h), determined by substituting the term “domestic corporation” for the term “controlled foreign corporation,”

and without regard to the phrase “located in a country other than the United States” in section 954(h)(3)(A)(ii)(I) and without regard to any inference that the tests in section 954(h) should be calculated or determined without taking into account transactions with customers located in the United States. In all three of these cases, however, the special rule for substitute property could still apply.

c. Regulations implementing the passive assets rule

Section 1.7874-7T sets forth the passive assets rule as described in the 2014 notice and the 2015 notice, subject to certain modifications, in part, to address comments received. .

i. De Minimis Exception

A comment noted that certain rules described in the 2014 notice could cause section 7874 to apply to a domestic entity acquisition even though the former domestic entity shareholders or former domestic entity partners, as applicable, actually own no, or only a de minimis amount of, stock in the foreign acquiring corporation after the domestic entity acquisition. In the context of the passive assets rule this could occur, for example, if a foreign acquiring corporation, which holds only cash that does not give rise to disqualified stock under §1.7874-4T, acquires the stock of the domestic entity in exchange for a portion of the cash and a small amount of stock of the foreign acquiring corporation. Because the foreign group property would be comprised entirely of the remaining cash held by the foreign acquiring corporation, 100 percent of the gross value of all foreign group property would constitute foreign group nonqualified property. Accordingly, absent a de minimis exception, all of the stock of the foreign acquiring corporation, other than stock described in section 7874(a)(2)(B)(ii) (that is, by-reason-of

stock), would be excluded from the denominator of the ownership fraction pursuant to the passive assets rule, resulting in an ownership fraction of 100 percent. In response to the comment, and for reasons similar to the reasons for the de minimis exceptions in §1.7874-4T and the NOCD rule (described in Section 5 of this Part I.B), the Treasury Department and the IRS have determined that there should be a de minimis exception to the passive assets rule.

Accordingly, §1.7874-7T(c) provides a de minimis exception when two requirements are satisfied: (i) first, the ownership percentage—determined without regard to the application of the passive assets rule, §1.7874-4T(b), and the NOCD rule (described in Section 5 of this Part I.B)—is less than five (by vote and value); and (ii) second, on the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete (the completion date), former domestic entity shareholders or former domestic entity partners, as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the EAG.

#### ii. Assets Upstream of the Foreign Acquiring Corporation

The 2014 notice would treat property held by an EAG member as foreign group property regardless of whether the foreign acquiring corporation directly or indirectly owned an interest in the property. Thus, in cases in which the foreign acquiring corporation is not the common parent of the EAG, the 2014 notice could treat property as foreign group property even though the value of the property is not reflected in the value of the stock of the foreign acquiring corporation.

The Treasury Department and the IRS have concluded that foreign group property should not include property held by EAG members if the value of such property is not reflected in the value of the stock of the foreign acquiring corporation. In order to effectuate this policy, the temporary regulations limit foreign group property to property held by members of the “modified expanded affiliated group.” See §1.7874-7T(f)(2) (defining foreign group property). When the foreign acquiring corporation is not the common parent corporation, the modified EAG is the EAG redetermined as if the foreign acquiring corporation were the common parent corporation. See §1.7874-7T(f)(4) (defining modified expanded affiliated group).

In connection with this change, the temporary regulations also modify the definition of foreign group property provided in the 2014 notice to exclude only stock or partnership interests in members of the modified EAG and obligations of such members, since the issue of double-counting only arises with respect to those interests.

### iii. Certain Nonqualified Property that Gives Rise to Disqualified Stock

A comment questioned whether, for purposes of the more-than-50-percent threshold test, foreign group property should include certain nonqualified property (within the meaning of §1.7874-4T(i)(7)) received by the EAG in a transaction related to the domestic entity acquisition. In particular, the comment noted that nonqualified property received by the EAG in such a transaction may (i) if received in exchange for stock of the foreign acquiring corporation, give rise to disqualified stock (within the meaning of §1.7874-4T(c)) that is excluded from the denominator of the ownership fraction under §1.7874-4T(b), and (ii) because such property is foreign group nonqualified property, increase the likelihood that the more-than-50-percent threshold

will be exceeded and thus that additional stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction under the passive assets rule.

The Treasury Department and the IRS have determined that the more-than-50-percent threshold test should apply without regard to whether all or a portion of the foreign group nonqualified property was received in a transaction related to the domestic entity acquisition. The more-than-50-percent threshold test is an on-off switch that is intended to determine whether, after the domestic entity acquisition and all related transactions are complete, a majority of the value of the stock of the foreign acquiring corporation is attributable to nonqualified property; other aspects of the passive assets rule coordinate its operation with the other anti-abuse rules under section 7874. Accordingly, the temporary regulations confirm that, for purposes of the more-than-50-percent threshold test, foreign group property includes nonqualified property that gives rise to disqualified stock that is excluded from the denominator of the ownership fraction pursuant to §1.7874-4T(b). See §1.7874-7T(f)(2). However, as is the case under the 2014 notice, §1.7874-7T(b) does not exclude from the denominator of the ownership fraction any stock of the foreign acquiring corporation that is attributable to such property. See §1.7874-7T(f)(3). Stock attributable to such property is instead excluded from the denominator of the ownership fraction under §1.7874-4T(b).

#### iv. Valuing Foreign Group Property

A comment recommended providing a safe harbor to facilitate the valuation of foreign group property. The comment noted that the value of certain property,

particularly illiquid property, may be difficult or costly to determine, especially in the case of a foreign acquiring corporation that is not publicly traded.

After considering this comment, the Treasury Department and the IRS decline to provide such a safe harbor. A domestic entity acquisition is likely to be an infrequent occurrence for a foreign acquiring corporation. Furthermore, as a general matter, the value of foreign group property must be established in order to determine the amount of stock of the foreign acquiring corporation that must be provided in the domestic entity acquisition. Therefore, it should not be unduly burdensome to determine the aggregate gross value of foreign group property and foreign group nonqualified property.

#### v. Exclusions from General Definition of Foreign Group Nonqualified Property

A comment requested that the regulations clarify that the exclusions from the general definition of foreign group nonqualified property for certain property that gives rise to income described in section 954(h) or (i) apply regardless of whether section 954(h) or (i) sunset. However, section 128 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114-113, 129 Stat. 2242) made sections 954(h) and (i) permanent. Therefore, this comment is no longer relevant and is not adopted.

Another comment requested that the Treasury Department and the IRS clarify that references in the regulations to section 954(h) or (i) or section 1297(b)(2)(A) or (B) incorporate the principles of any regulations or other guidance issued pursuant to those Code sections. In this regard, the Treasury Department and the IRS note that as a general matter, unless otherwise indicated, a reference in a regulation to a Code section implicitly includes any regulations or other guidance issued pursuant to that Code section. Accordingly, the comment is not adopted.

## vi. Treatment of Partnerships

The 2014 notice did not explicitly address the treatment of partnerships under the passive assets rule. Similar to §1.7874-4T(g), the temporary regulations provide that, if one or more members of an EAG (for this purpose, taking into account only members of the modified EAG as described in Section ii of this Part I.B.2.c) own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, then, for purposes of the passive assets rule, the partnership is treated as a corporation that is a member of the EAG (deemed corporation rule). See §1.7874-7T(d).

The temporary regulations implementing the passive assets rule do not include a rule analogous to that provided in §1.7874-3(e)(1), which treats certain corporate partners of a partnership that owns stock of a foreign acquiring corporation as members of the EAG for purposes of applying the substantial business activities test. Such a rule is not necessary because, as described in Section ii of this Part I.B.2.c, assets that are upstream of the foreign acquiring corporation are not taken into account as foreign group property for purposes of applying the passive assets rule.

## 3. Acquisitions of Multiple Domestic Entities

### a. Transactions at issue

The Treasury Department and the IRS are concerned that a single foreign acquiring corporation may avoid the application of section 7874 by completing multiple domestic entity acquisitions over a relatively short period of time, in circumstances where section 7874 would otherwise have applied if the acquisitions had been made at the same time or pursuant to a plan (or series of related transactions). In these situations, the value of the foreign acquiring corporation increases to the extent it issues

stock in connection with each successive domestic entity acquisition, thereby enabling the foreign acquiring corporation to complete another, potentially larger, domestic entity acquisition to which section 7874 will not apply. In some cases, a substantial portion of the value of a foreign acquiring corporation may be attributable to its completion of multiple domestic entity acquisitions over the span of just a few years, with that value serving as a platform to complete still larger subsequent domestic entity acquisitions that avoid the application of section 7874. That is, the ownership percentage determined with respect to a subsequent domestic entity acquisition may be less than 60, or less than 80, if the shares of the foreign acquiring corporation issued in prior domestic entity acquisitions are respected as outstanding (thus, included in the denominator but not the numerator) when determining the ownership fraction.

Section 7874 is intended to address transactions in which a domestic parent corporation of a multinational group is replaced with a foreign parent corporation while “permit[ting] corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion.” S. Rep. No. 192, at 142 (2003); JCT Explanation, at 343. To further this policy, various rules under section 7874 exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation that otherwise would inappropriately reduce the ownership fraction. For example, the statutory public offering rule of section 7874(a)(2)(B) excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation that is sold for cash in a public offering related to the domestic entity acquisition. For the same reason, rules under §§1.7874-4T and 1.7874-7T exclude from the denominator of the



ownership fraction certain stock of the foreign acquiring corporation that is transferred in exchange for, or otherwise attributable to, passive assets or other nonqualified property.

The Treasury Department and the IRS have concluded that it is not consistent with the purposes of section 7874 to permit a foreign acquiring corporation to reduce the ownership fraction for a domestic entity acquisition by including stock issued in connection with other recent domestic entity acquisitions. Moreover, the Treasury Department and the IRS do not believe that the application of section 7874 in these circumstances should depend on whether there was a demonstrable plan to undertake the subsequent domestic entity acquisition at the time of the prior domestic entity acquisitions. Therefore, and consistent with the policies underlying the other stock exclusion rules under section 7874, the Treasury Department and the IRS have determined that stock of the foreign acquiring corporation that was issued in connection with certain prior domestic entity acquisitions occurring within a 36-month look-back period should be excluded from the denominator of the ownership fraction.

b. Disregard of stock attributable to certain domestic entity acquisitions

To address these concerns, the temporary regulations provide a rule under section 7874(c)(6) and (g) that, for purposes of calculating the ownership percentage by value with respect to a domestic entity acquisition (the relevant domestic entity acquisition), excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain prior domestic entity acquisitions. This rule (the multiple domestic entity acquisition rule) applies if, within the 36-month period ending on the signing date with respect to the relevant domestic entity acquisition, the foreign acquiring corporation (or a predecessor) completed one or more

other domestic entity acquisitions that are not excluded under an exception (each such other domestic entity acquisition, a prior domestic entity acquisition). For this purpose, the signing date is the first date on which the contract to effect the relevant domestic entity acquisition is binding, or if another binding contract to effect a substantially similar acquisition was terminated with a principal purpose of avoiding section 7874, the first date on which such other contract was binding. In general, a domestic entity acquisition is excluded from the definition of a prior domestic entity acquisition if (i) the ownership percentage with respect to such domestic entity acquisition was less than five, and (ii) the fair market value of the by-reason-of stock received by the former domestic entity shareholders or former domestic entity partners did not exceed \$50 million.

In general, the amount of foreign acquiring corporation stock that is excluded under the multiple domestic entity acquisition rule is based on the current value of the shares of foreign acquiring corporation stock that were issued in the prior domestic entity acquisition, adjusted to reflect intervening redemptions of stock as well as certain other changes in the capital structure of the foreign acquiring corporation. The Treasury Department and the IRS have determined that this approach, which takes into account subsequent fluctuations in value attributable to the prior domestic entity acquisition, best reflects the policies underlying section 7874, including the ownership fraction.

The temporary regulations provide a three-step process to determine the excluded amount for each prior domestic entity acquisition. First, the total number of shares of stock of the foreign acquiring corporation, within each separate share class (relevant share class), that was described in section 7874(a)(2)(B)(ii) as a result of the prior domestic entity acquisition (without regard to whether the 60 percent test of section

7874(a)(2)(B)(ii) was satisfied) must be calculated (total number of prior acquisition shares). For this purpose, it is not relevant whether a share is outstanding at the time of the relevant domestic entity acquisition.

Second, for each relevant share class, the total number of prior acquisition shares must be adjusted to account for redemptions (within the meaning of section 317(b)) of shares that occur during the redemption testing period (each such share, a redeemed share) and that are attributed, on a pro rata basis, to the prior acquisition shares. In general, the redemption testing period is the period beginning on the day after the completion date of the prior domestic entity acquisition and ending on the day prior to the completion date of the relevant domestic entity acquisition (the general redemption testing period). §1.7874-8T(e)(1). The number of redeemed shares is then multiplied by the redemption fraction (such product, the allocable redeemed shares). §1.7874-8T(d)(1). The numerator of the redemption fraction is generally the total number of prior acquisition shares, and the denominator is the sum of: (i) the number of outstanding shares of the foreign acquiring corporation stock as of the end of the last day of the redemption testing period, and (ii) the number of redeemed shares during the redemption testing period.

By ending the redemption testing period on the day prior to the completion date of the relevant domestic entity acquisition, shares issued on such completion date would not dilute the portion of a prior redemption that is allocated to the prior acquisition shares. However, to prevent other stock issuances that occur after a particular redemption from diluting the amount of allocable redeemed shares, a foreign acquiring corporation may establish a reasonable method for dividing the general redemption

testing period into shorter periods (each such shorter period, a redemption testing period). §1.7874-8T(e)(2). In these cases, to account for the fact that the total number of prior acquisition shares is reduced by the allocable redeemed shares for each redemption testing period, the numerator of the redemption fraction for a redemption testing period is the total number of prior acquisition shares less the sum of the number of allocable redeemed shares for prior redemption testing periods. §1.7874-8T(d)(2)(i).

Finally, for each relevant share class, the total number of prior acquisition shares, reduced to take into account redemptions, is multiplied by the fair market value of a single share of stock of the relevant share class, as of the completion date of the relevant domestic entity acquisition (such product, an excluded amount). §1.7874-8T(c). The total amount of stock of the foreign acquiring corporation excluded from the denominator of the ownership fraction is the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class. §1.7874-8T(b).

The temporary regulations also require appropriate adjustments to be made to take into account changes in a foreign acquiring corporation's capital structure to ensure that the amount of stock excluded under the multiple domestic entity acquisition rule properly reflects the value attributable to prior domestic entity acquisitions. See §1.7874-8T(f).

The multiple domestic entity acquisition rule applies after taking into account the rule in §1.7874-2(e). The rule in §1.7874-2(e) applies when a foreign acquiring corporation completes two or more domestic entity acquisitions pursuant to a plan (or series of related transactions). In such a case, for purposes of section 7874(a)(2)(B)(ii),

the acquisitions are treated as a single acquisition, and the domestic entities are treated as a single domestic entity. Thus, for example, if two acquisitions that would separately qualify as a relevant domestic entity acquisition and a prior domestic entity acquisition are subject to §1.7874-2(e), they are treated as a single acquisition and, as a result, would not be subject to the multiple domestic entity acquisition rule. Similarly, if two acquisitions that would separately be treated as two prior domestic entity acquisitions are subject to §1.7874-2(e), they are treated as a single prior domestic entity acquisition for purposes of applying the multiple domestic entity acquisition rule.

#### 4. Third-Country Rule

##### a. Background

Section 2.02(b) of the 2015 notice announces that the Treasury Department and the IRS intend to issue regulations providing a rule (the third-country rule) that will apply to certain domestic entity acquisitions in which a domestic entity combines with an existing foreign corporation under a foreign parent corporation that is a tax resident of a “third country” (that is, a foreign country other than the foreign country of which the existing foreign corporation is subject to tax as a resident). The 2015 notice provides that the third-country rule will apply when four requirements are satisfied. First, in a transaction (referred to in the 2015 notice as a “foreign target acquisition” but in this preamble and the temporary regulations as a “foreign acquisition”) related to the domestic entity acquisition, the foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by another foreign corporation (the acquired foreign corporation). Second, the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign

acquisition exceeds 60 percent of the gross value of all foreign group property, other than foreign group nonqualified property, held by the EAG on the completion date (the gross value requirement). Third, the tax residence of the foreign acquiring corporation is not the same as that of the acquired foreign corporation, as determined before the foreign acquisition and any related transaction (the tax residency requirement). And fourth, the ownership percentage, determined without regard to the third-country rule, must be at least 60 but less than 80 (the domestic entity ownership requirement). As explained in Section b of this Part II.B.4, the temporary regulations retain the first, third, and fourth requirements described in the 2015 notice but replace the second requirement with a new requirement.

When these requirements are satisfied, the 2015 notice provides that the third-country rule will exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation held by former shareholders of the acquired foreign corporation by reason of holding stock in the acquired foreign corporation (based on the principles of section 7874(a)(2)(B)(ii), which describes by-reason-of stock).

b. Regulations implementing the third-country rule

Section 1.7874-9T sets forth the third-country rule as described in the 2015 notice, subject to certain modifications.

The temporary regulations replace the gross value requirement contained in the 2015 notice with a continuity of interest requirement (referred to as the “foreign ownership percentage”). See §1.7874-9T(d)(3) and (4). In general, this requirement is satisfied if at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the acquired foreign corporation by reason

of holding stock in the acquired foreign corporation, as determined under the principles of section 7874(a)(2)(B)(ii), with certain modifications. §1.7874-9T(e)(3) and (4). For this purpose, stock of the foreign acquiring corporation held by former domestic entity shareholders (or former domestic entity partners) is not taken into account. See §1.7874-9T(e)(3)(i). Because a domestic entity acquisition is disregarded for this purpose, it does not dilute the foreign ownership percentage. The temporary regulations implement this modification by requiring that there be a covered foreign acquisition, generally defined as a transaction in which there is an acquisition of substantially all of the properties of a foreign corporation (that is, a foreign acquisition) and in which the foreign ownership percentage is at least 60. This modification aligns the requirements for the third-country rule with the principles of section 7874.

The temporary regulations generally retain the domestic entity ownership and tax residency requirements as described in the 2015 notice. However, the temporary regulations clarify the application of the tax residency requirement by providing that the tax residency of the foreign acquiring corporation is determined after the covered foreign acquisition and all related transactions, and that the tax residency of the acquired foreign corporation is determined before the covered foreign acquisition and all related transactions.

## 5. Non-Ordinary Course Distributions (NOCD) Rule

### a. Overview

The 2014 notice announced that the Treasury Department and the IRS intend to include in future regulations under section 7874 a rule (the NOCD rule) that disregards certain distributions made by a domestic entity before being acquired by a foreign

acquiring corporation that otherwise would reduce the numerator of the ownership fraction. Specifically, section 2.02(b) of the 2014 notice provides that, for purposes of applying section 7874(c)(4), NOCDs made by the domestic entity (including a predecessor) during the 36-month period ending on the completion date will be treated as part of a plan a principal purpose of which is to avoid the purposes of section 7874.

The 2014 notice defines NOCDs as the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year. The 2014 notice defines distribution, in relevant part, to mean any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under section 355.

Section 4.02(b) of the 2015 notice provides that the future regulations incorporating the NOCD rule will include a de minimis exception. The 2015 notice provides that this exception, similar to the de minimis exception in §1.7874-4T(d)(1), will apply to an acquisition that satisfies two requirements. First, the ownership percentage—determined without regard to §1.7874-4T(b) (which disregards certain stock of the foreign acquiring corporation received in exchange for nonqualified property), the passive assets rule, and the NOCD rule—must be less than five (by vote and value). Second, after the domestic entity acquisition and all transactions related to the acquisition are complete, former domestic entity shareholders or former domestic entity partners, as applicable, of the domestic entity, in the aggregate, must own (applying the attribution rules of section 318(a) with the modifications described in



section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) any member of the EAG.

The 2015 notice provides that, when a domestic entity acquisition satisfies the requirements of the de minimis exception, no distributions will be treated as NOCDs that are disregarded under the NOCD rule. The 2015 notice further provides, however, that even when a domestic entity acquisition satisfies the requirements of the de minimis exception, distributions that are part of a plan a principal purpose of which is to avoid the purposes of section 7874, determined without regard to the NOCD rule, will nevertheless be disregarded under section 7874(c)(4).

Further, the 2014 notice provides that §1.367(a)-3(c) (concerning outbound transfers of stock or securities of a domestic corporation) will be modified to include a rule that incorporates the principles of the NOCD rule for purposes of the substantiality test, which, in general, requires that the value of the foreign acquiring corporation be equal to or greater than the value of the domestic target corporation.

#### b. Regulations implementing the NOCD rule

Section 1.7874-10T sets forth the NOCD rule as described in the 2014 notice and the 2015 notice, subject to certain modifications, in part, to address comments received. Section 1.367(a)-3T(c)(3)(iii)(C) sets forth a similar rule for purposes of the substantiality test under §1.367(a)-3(c).

#### i. In General

Section 1.7874-10T(b) generally provides that, for purposes of determining the ownership percentage by value, former domestic entity shareholders or former domestic entity partners, as applicable, are deemed to receive, by reason of holding stock or an interest in the domestic entity, an amount of stock of the foreign acquiring corporation

with a fair market value equal to the aggregate value of NOCDs made by the domestic entity (NOCD stock). Thus, similar to the rule under §1.7874-2(h)(1) (regarding the treatment of options for purposes of determining the ownership percentage), the NOCD rule does not apply for purposes of determining the ownership percentage by vote. Similar to the rule addressing voting power in §1.7874-2(h)(2), however, section 7874(c)(4) will nonetheless disregard distributions for purposes of determining the ownership percentage by vote that, without regard to the NOCD rule, are part of a plan a principal purpose of which is to avoid the purposes of section 7874.

The temporary regulations provide, consistent with the approach recommended in comments received, that the amount of a distribution (including with respect to property distributed in redemption of stock) is determined based on the value of the property distributed at the time of the distribution. See §1.7874-10T(b). Accordingly, post-distribution fluctuations in the value of the stock or interests of the domestic entity, as applicable, or the value of the distributed property (for example, in the case of a spin-off), do not affect the amount of NOCD stock that is deemed received. A comment suggested additional guidance on valuing the stock of controlled corporations in spin-off transactions. The temporary regulations do not provide new guidance on this issue, which extends beyond the scope of the NOCD rule.

A comment generally recommended that, for purposes of determining the extent to which NOCD stock is deemed received, the NOCD rule should take into account the mix of stock and non-stock consideration provided by a foreign acquiring corporation. For example, if the foreign acquiring corporation acquires a domestic entity in exchange for 60 percent stock and 40 percent cash, the comment recommended that only 60

percent of the additional consideration deemed received under the NOCD rule would be treated as consisting of NOCD stock (with the remaining 40 percent of the additional consideration treated as consisting of cash and, to this extent, not increasing the ownership percentage). The same comment indicated that, under such an approach, additional guidance would be needed in certain cases in which a domestic entity had multiple classes of stock outstanding, particularly where the foreign acquiring corporation does not have a similar capital structure.

The NOCD rule is intended to address transactions in which a taxpayer elects to reduce its size by making distributions outside of the ordinary course to shareholders in order to reduce the amount of foreign acquiring stock that would have to be provided to such shareholders in a subsequent domestic entity acquisition. The Treasury Department and the IRS have determined that the mix of additional consideration that would have been provided in the subsequent domestic entity acquisition but for the NOCDs could differ from the mix of consideration that was actually provided in the domestic entity acquisition. This could occur, for example, due to limitations on the amount of cash that the foreign acquiring corporation was financially capable of providing. It is in fact this type of limitation that could motivate a domestic entity to make NOCDs in order to reduce the ownership percentage, rather than relying on cash consideration provided by the foreign acquiring corporation. In addition, the Treasury Department and the IRS have concluded that determining the hypothetical mix of consideration that would have been provided in the absence of NOCDs would give rise to significant administrative complexities. Accordingly, the temporary regulations do not

adopt this comment, and, therefore, also do not provide guidance specific to cases where a domestic entity has, or had, multiple classes of stock outstanding.

A comment also requested clarification that the NOCD rule does not establish a safe harbor with respect to the application of section 7874(c)(4). Specifically, the comment requested clarification that, when a distribution is not disregarded under the NOCD rule, the distribution may nevertheless be disregarded under section 7874(c)(4) if, without regard to the NOCD rule, it was made with a principal purpose of avoiding the purposes of section 7874. The temporary regulations confirm that this is the case. See §1.7874-10T(c). In addition, and also in response to a comment, the temporary regulations clarify that, when only a portion of a distribution is treated as an NOCD, the NOCD rule does not create a presumption that the remaining portion of the distribution was made with a principal purpose of avoiding the purposes of section 7874. See *id.* The remaining portion must be analyzed under section 7874(c)(4) in the same manner as any other distribution that is not treated as an NOCD.

Comments requested clarification regarding whether the NOCD rule could apply for purposes other than the ownership fraction. For example, the comments questioned whether property distributed as part of an NOCD could be considered held by the EAG for purposes of determining whether the EAG has substantial business activities in the relevant foreign country. The temporary regulations confirm that the NOCD rule applies only for purposes of determining the ownership percentage by value; it therefore does not apply for any other purpose, including, for example, the substantial business activities determination under §1.7874-3 or the loss of control exception under §1.7874-1(c)(3). Nevertheless, the scope of section 7874(c)(4), by its terms, is not limited to the

ownership fraction and therefore may apply for other purposes under section 7874. See also, for example, §1.7874-3(c), which provides anti-abuse rules pursuant to which certain items are not taken into account for purposes of the substantial business activities test, including items associated with properties or liabilities the transfer of which is disregarded under section 7874(c)(4).

## ii. Scope of the NOCD Rule

Comments recommended narrowing the NOCD rule. For example, comments suggested that the NOCD rule should only create, either in all cases or at least with respect to section 355 distributions, a rebuttable presumption that a distribution identified as an NOCD under the rule is made with a principal purpose of avoiding the purposes of section 7874. Under this approach, if a taxpayer demonstrated that a distribution presumptively identified as an NOCD was not in fact made with a principal purpose of avoiding the purposes of section 7874, then the distribution would not be disregarded. A comment did note, though, that difficulties, uncertainties, and administrative burdens could arise under a rebuttable presumption approach. After considering the comments received, the Treasury Department and the IRS have determined that replacing the per se NOCD rule with a rebuttable presumption would give rise to significant uncertainty and administrative burden because the IRS would face significant challenges in ascertaining the purpose underlying each distribution. Accordingly, the temporary regulations do not adopt this approach.

A comment suggested that, if a non-rebuttable presumption is retained, the NOCD rule should be narrowed by other means, such as by (i) replacing the 36-month period during which distributions are subject to being disregarded under the NOCD rule

with a 24-month period, (ii) increasing the 110% threshold, or (iii) excluding certain distributions (such as section 355 distributions, as well as certain other distributions) from the definition of distribution provided in the 2014 notice. This comment acknowledges that the adoption of many or all of these proposals, at the margins, could exempt certain tax-motivated distributions from the mechanical NOCD rules, but suggests that the IRS could nonetheless use its authority to disregard such distributions under the general anti-avoidance rule of section 7874(c)(4). After considering these comments, the Treasury Department and the IRS have concluded that these changes could inappropriately facilitate the use of distributions made with a principal purpose of avoiding the purposes of section 7874. For example, excluding section 355 distributions from the definition of distribution would undermine one of the purposes of the NOCD rule, which is to address certain section 355 distributions in which a domestic distributing corporation distributes one or more lines of business in order to facilitate a future inversion by either the controlled corporation or itself based on a business combination with a foreign corporation that may or may not have been definitively identified. Similarly, with respect to the 36-month period, a comment suggests that it is unlikely that a taxpayer would be able to determine 36 months before a particular transaction the amount of distributions that would be required to reduce the ownership percentage below 60% or 80% on the completion date. Large transactions, however, can take many months to close. Moreover, some companies that wish to pursue an inversion but have not yet definitively identified a foreign target may use NOCDs to reduce their size in order to expand the pool of appropriately-sized target companies. Accordingly, the Treasury Department and the IRS have determined that the

parameters described in the 2014 notice and the 2015 notice strike the right balance between exempting non-abusive transactions from the NOCD rule and providing an administrable rule to address tax-motivated transactions. In particular, for the reasons described previously for not converting the NOCD rule into a rebuttable presumption, the Treasury Department and the IRS have concluded that the general anti-avoidance rule under section 7874(c)(4) would not be an effective backstop to looser objective tests. Accordingly, the temporary regulations do not adopt these recommendations.

Other comments suggested that the regulations should exclude the following distributions from the NOCD rule because they ordinarily would not give rise to avoidance concerns: (i) dividends or redemptions made pursuant to a policy that is carried out consistently for the 36-month period preceding the completion date; (ii) intercompany distributions by a controlled corporation to its corporate shareholder, before the latter distributes the former in a spin-off transaction; (iii) certain redemptions of preferred stock; and (iv) in the case of a domestic entity that is a domestic partnership, certain partnership distributions. These changes are not adopted in the temporary regulations because each type of distribution implicates the fundamental concern that it reduces the value of the domestic entity. Furthermore, the Treasury Department and the IRS have concluded that crafting an “angel list” of categories of distributions would make the NOCD rule more complex and in some cases could lead to inappropriate results. As an example of additional complexity, to produce symmetrical results, it would be necessary to distinguish these types of distributions from other distributions and exclude them not only from the look-back period, but also from the distribution history period (as described in Section iii of this Part I.B.5.b). Another

comment suggested that aggregate distributions during a period be calculated by netting distributions against certain capital contributions. Although netting distributions against contributions could more accurately reflect any reduction in the value of the domestic entity, it would require additional rules to identify which contributions and distributions are appropriate to net, raising the same complexity concerns as the other comments. The Treasury Department and IRS also note that netting is not allowed in other settings, for example, in the excess distribution regime under section 1291 (which applies to passive foreign investment companies) and in §1.7874-4T (which applies to domestic entity acquisitions). In particular, §1.7874-4T does not allow for a foreign acquiring corporation to net the amount of disqualified stock, the issuance of which increases its value, against distributions it makes. In sum, the Treasury Department and the IRS have determined that the NOCD rule should operate as a bright-line rule, testing whether a domestic entity's value-decreasing distributions exceed a threshold amount. For this reason, and in response to a comment, the temporary regulations exclude from the definition of a distribution certain distributions described in sections 304 and 305 because they do not reduce the domestic entity's value. See §1.7874-10T(h)(1)(i)(A) and (B).

### iii. Determining NOCDs

The temporary regulations set forth five steps for determining the amount of NOCDs. The first step is to identify the look-back period, that is, the period during which distributions are subject to being disregarded under the NOCD rule. Under §1.7874-10T(h)(4), the look-back period means the 36-month period ending on the completion date or, if shorter, the entire period starting with the formation date



(described in §1.7874-10T(h)(3) as the earliest of the dates that the domestic entity and any predecessor were created or organized) and ending on the completion date.

The next step is to divide the look-back period into look-back years. Although the 2014 notice contemplated using a taxable-year convention to determine a look-back year, a taxable-year convention may create undue complexity or uncertainty when—as noted in a comment—the completion date is not the last day of the domestic entity’s taxable year, or when the domestic entity (or any predecessor) has a short taxable year. Because a 12-month convention more simply addresses these situations and thus provides for a more administrable NOCD rule, the Treasury Department and the IRS have determined that a 12-month convention should be used to determine a look-back year. Accordingly, the temporary regulations provide that a look-back year generally means any of the three consecutive 12-month periods that comprise the look-back period. See §1.7874-10T(h)(5)(i). The temporary regulations also provide special rules for determining look-back years when the look-back period is less than 36 months. See §1.7874-10T(h)(5)(ii) through (iv).

Once the look-back years have been determined, the distribution history period for each look-back year must be identified. The distribution history period for a look-back year generally means the 36-month period preceding the start of the look-back year. §1.7874-10T(h)(2)(i). In response to a comment, the temporary regulations provide special rules for determining the distribution history period for a look-back year that is not preceded by 36 months of history. In particular, §1.7874-10T(h)(2)(ii) provides that when the formation date is less than 36 months, but at least 12 months, before the start of a look-back year, then the distribution history period for that look-back

year means the entire period, starting with the formation date, that precedes the start of the look-back year. Section 1.7874-10T(h)(2)(iii) provides that, when a look-back year is preceded by less than 12 months of history, then the look-back year is considered to not have a distribution history period.

Next, the NOCD threshold for each look-back year must be calculated. Except for a look-back year that does not have a distribution history period, the NOCD threshold for a look-back year means 110 percent of the sum of the distributions made during the distribution history period for that look-back year multiplied by a fraction. §1.7874-10T(h)(7)(i). The numerator of the fraction is the number of days in the look-back year at issue, and the denominator of the fraction is the number of days in the distribution history period for that look-back year. *Id.* Thus, if a look-back year has a 36-month distribution history period, the NOCD threshold for that look-back year would be 110 percent of the distributions in the 36-month distribution history period, multiplied by  $\frac{1}{3}$  (simplified from  $\frac{365}{1095}$ ). Similarly, if a look-back year has only a 12-month distribution history period, then the NOCD threshold for that look-back year generally would be 110 percent of the distributions in the 12-month distribution history period, multiplied by 1 (simplified from  $\frac{365}{365}$ ). For a look-back year that does not have a distribution history period, the NOCD threshold is zero. §1.7874-10T(h)(7)(ii).

The last step for determining the amount of NOCDs is to calculate, for each look-back year, the excess, if any, of all distributions made during the look-back year over the NOCD threshold for the look-back year. Under §1.7874-10T(h)(6), the excess amounts constitute NOCDs.

One comment suggested an aggregate approach to determining NOCDs under which NOCDs would mean the excess of all distributions during the look-back period over 110 percent of the aggregate distributions made during the 36-month period preceding the look-back period. The approach described in the preceding paragraphs is generally consistent with the approach used in other areas of the Code. See, for example, sections 172(g)(3)(C) and 1291(b)(1). Moreover, for a domestic entity that has otherwise had a consistent distribution practice during the look-back period, the approach suggested by the comment would facilitate larger distributions than are intended to be permitted under the NOCD rule in the year preceding the domestic entity acquisition, the year in which abusive distributions are most likely. As a result, the Treasury Department and the IRS decline to adopt the recommendation.

#### iv. Predecessors

In response to a comment, the temporary regulations provide that a corporation or partnership (relevant entity) is treated for all purposes of the NOCD rule—including for purposes of look-back year calculations, distribution history period calculations, and NOCD threshold calculations—as having made distributions that were made by a predecessor of the relevant entity (the predecessor rule). §1.7874-10T(e). Under the predecessor rule, a domestic entity “inherits” distributions made by a predecessor (and, such a predecessor could also be a relevant entity that inherits distributions made by a predecessor with respect to it).

##### (a) Purposes of the predecessor rule

The predecessor rule serves two purposes. First, the predecessor rule prevents potential avoidance of the NOCD rule. For example, absent the predecessor rule, a domestic corporation that would be treated as having NOCDs under the NOCD rule

might, in anticipation of a domestic entity acquisition, undergo a reorganization into a newly formed domestic corporation and take the position that the newly formed domestic corporation has no distributions to which the NOCD rule applies. In addition, upon the combination of two domestic corporations in a transaction before a domestic entity acquisition, the domestic corporations might, absent the predecessor rule, structure the combination such that the corporation with the more favorable distribution history serves as the surviving corporation. Although section 7874(c)(4) could apply to address these types of transactions even absent the predecessor rule, the Treasury Department and the IRS have determined that it is appropriate to specifically address these transactions through the predecessor rule.

Second, the predecessor rule increases the accuracy of NOCD calculations. That is, when two entities combine in a transaction that increases the value of the combined group (for example, in a transaction in which a substantial portion of the consideration issued by the acquiring entity consists of equity interests in the entity), the distribution-paying capacity of the combined group increases. As a result, the separate distribution histories of the entities should be combined pursuant to the predecessor rule because, otherwise, post-combination distributions (which are funded by the earnings of both entities) might be compared to an NOCD threshold that is inappropriately low (that is, an NOCD threshold that takes into account the distribution history of only the acquiring entity).

(b) Definition of predecessor

In response to comments, the temporary regulations provide guidance on the meaning of predecessor. In particular, the temporary regulations provide that an entity

(tentative predecessor) is a predecessor of another entity (relevant entity) when two requirements are satisfied. First, the relevant entity must complete a predecessor acquisition, which occurs when a relevant entity directly or indirectly acquires substantially all of the properties held directly or indirectly by the tentative predecessor. See §1.7874-10T(f)(1)(i) and (f)(2)(i). Second, after the predecessor acquisition and all related transactions are complete, at least 10 percent of the stock (or interests) in the relevant entity must be held by reason of holding stock (or interests) in the tentative predecessor. See §1.7874-10T(f)(1)(ii) and (f)(3).

The second requirement generally ensures that only transactions that result in a meaningful increase in the value of the relevant entity result in the predecessor's history being inherited by the relevant entity. The second requirement also generally ensures that, before the predecessor acquisition, the fair market value of the tentative predecessor is greater than a de minimis portion of the fair market value of the relevant entity. Accordingly, and in response to a comment, the second requirement generally prevents a tentative predecessor from being a predecessor in cases in which the utility of the relevant entity inheriting the historic distributions of the tentative predecessor could be outweighed by the potentially complicated due diligence required to determine those historic distributions. On the other hand, the Treasury Department and the IRS determined that it is not appropriate to condition predecessor status on a tentative predecessor being larger in value than the relevant entity at the time of the predecessor acquisition, as was suggested by a comment. Such a narrow definition of predecessor would not appropriately reflect the second, accuracy-related purpose of the predecessor

rule, which requires taking into account the increase in the dividend-paying capacity of the combined entity.

(c) Distributions inherited by the domestic entity

Under the temporary regulations, when there is a predecessor of a relevant entity, the relevant entity inherits the full amount of any distributions made by the predecessor before the predecessor acquisition. §1.7874-10T(e)(1). The relevant entity also inherits the full amount of any transfer of money or other property to the former owners of the predecessor that is made in connection with the predecessor acquisition, to the extent the money or other property was directly or indirectly provided by the predecessor. See §1.7874-10T(e)(2); see also §1.7874-10T(h)(1)(iv).

v. Domestic Entity Deemed to Have Distributed Stock of a Distributing Corporation in Certain Cases

A comment noted that, in cases in which a foreign corporation wishes to acquire only a portion of a domestic corporation's properties, different results may arise under the NOCD rule depending on how the parties structure the acquisition and related transactions. Consider, for example, a situation in which a domestic parent corporation (DP) owns two businesses, Business A (\$600 fair market value) and Business B (\$400 fair market value), and a foreign corporation (FA) wishes to acquire Business A in exchange for FA stock. Under one structure, DP could contribute Business B to a newly formed domestic corporation (DC) and then distribute the stock of DC to its shareholders, followed by FA acquiring all the stock of DP in exchange for \$600 of FA stock. Under another structure, DP could contribute Business A to DC and then distribute the stock of DC to its shareholders, followed by FA acquiring all the stock of DC in exchange for \$600 of FA stock. In the first scenario, because the \$400 of value

attributable to Business B was distributed by the domestic entity (DP), the NOCD rule would take into account the value of Business B. In the second scenario, however, the NOCD rule would not take into account the \$400 of value of Business B, because the value of Business B was not distributed by the domestic entity (DC) and, moreover, DC would not inherit any portion of the distribution by DP of the DC stock. See §1.7874-10T(f)(1) (defining a predecessor).

The comment explained that examples like the one in the preceding paragraph demonstrate that, if in certain cases the direction of a spin-off is respected for purposes of the NOCD rule, then transactions that are substantively the same could give rise to vastly different results under the NOCD rule depending on the direction of the spin-off. The comment noted that this could lead to abuse of the NOCD rule. The Treasury Department and the IRS agree with the concerns raised by the comment. As a result, the temporary regulations provide a special rule pursuant to section 7874(g) that, for purposes of the NOCD rule, creates parity between certain transactions regardless of the direction of a spin-off. See §1.7874-10T(g).

The special rule in §1.7874-10T(g) applies when a domestic corporation (domestic distributing corporation) distributes stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355 and, immediately before the distribution, the value of the distributed stock represents more than 50 percent of the value of the domestic distributing corporation. When the special rule applies, the controlled corporation is deemed for purposes of the NOCD rule to have distributed the stock of the distributing corporation. The value of the deemed distribution is equal to the fair market value of the distributing corporation (but not taking

into account the fair market value of the stock of the controlled corporation) on the date of the distribution.

vi. NOCD Rule for Purposes of Section 367(a) Substantiality Test

The temporary regulations generally provide that, for purposes of the substantiality test in §1.367(a)-3(c)(3)(iii)(A), the fair market value of the U.S. target company includes the aggregate value of NOCDs made by the U.S. target company. §1.367(a)-3T(c)(3)(iii)(C). In this regard, NOCDs are calculated in the same manner as provided under §1.7874-10T. See *id.* Thus, regardless of whether the transfer of stock of the U.S. target company is part of a domestic entity acquisition, the amount of NOCDs under §1.367(a)-3T(c)(3)(iii)(C) is the same as the amount of NOCDs that would exist under §1.7874-10T.

One comment recommended a de minimis exception should apply to the NOCD rule as applied for purposes of the section 367(a) substantiality test. The comment suggested that the exception could be based on a fixed dollar amount or percentage of the U.S. target company, perhaps conditioned on a requirement that the distribution not have been motivated by the substantiality test. The temporary regulations adopt the comment's recommendation to provide a de minimis exception, but do not adopt the comment's recommended formulation of the exception. Rather, because the Treasury Department and IRS have concluded that the NOCD rule should apply consistently under sections 367 and 7874, the temporary regulations provide that the NOCD rule under section 367 does not apply if the de minimis exception in §1.7874-10T(d) would apply. See §1.367(a)-3T(c)(3)(iii)(C).

C. Subsequent transfers of stock of the foreign acquiring corporation and the EAG rules



## 1. In General

In general, section 7874 is intended to apply to transactions in which a U.S. parent corporation of a multinational corporate group is replaced by a foreign parent corporation without a significant change in the ultimate ownership of the group. See H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess., at 568 (2004). Congress intended the statutory EAG rule in section 7874(c)(2)(A) to prevent section 7874 from applying to certain transactions that do not give rise to inversion policy concerns. For example, section 7874 should not apply to transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction, such as the conversion of a wholly-owned domestic subsidiary into a new wholly-owned CFC. See JCT Explanation, at 344. In this regard, section 7874(c)(2)(A) provides that stock of a foreign acquiring corporation that is held by members of the EAG is not included in the numerator or the denominator of the ownership fraction (statutory EAG rule).

The application of the statutory EAG rule may not always lead to appropriate results, including when the domestic entity has minority shareholders. To address these cases, §1.7874-1 provides two exceptions to the statutory EAG rule: the internal group restructuring exception and the loss-of-control exception (together with the statutory EAG rule, the EAG rules). See §1.7874-1(c)(2) and (3), respectively. When either of these exceptions applies, stock of the foreign acquiring corporation held by members of the EAG is excluded from the numerator, but not the denominator, of the ownership fraction. In general, the internal group restructuring exception applies when the domestic entity and the foreign acquiring corporation are members of an affiliated group (generally based on an 80-percent vote-and-value requirement) with the same

common parent both before and after the acquisition. The loss-of-control exception applies when the former domestic entity shareholders or former domestic entity partners do not hold more than 50 percent of the stock of any member of the EAG after the acquisition. For additional background on these exceptions, see the preamble to TD 9238, published on December 28, 2005, in the **Federal Register** (70 FR 76685).

Section 1.7874-5T addresses the effect on the numerator of the ownership fraction when former domestic entity shareholders or former domestic entity partners receive stock of the foreign acquiring corporation by reason of holding stock or a partnership interest in the domestic entity and then transfer that stock to another person. Specifically, §1.7874-5T(a) provides that stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) shall not cease to be so described as a result of any subsequent transfer of the stock by the former domestic entity shareholder or former domestic entity partner that received the stock, even if the subsequent transfer is related to the domestic entity acquisition described in section 7874(a)(2)(B)(i). The preamble to that regulation notes that the Treasury Department and the IRS continue to study the extent to which subsequent transfers of stock of the foreign acquiring corporation should be taken into account in applying the EAG rules. See TD 9654, published on January 17, 2014, in the **Federal Register** (79 FR 3094, at 3099).

## 2. Rule Addressing Application of EAG Rules When There Is a Related Transfer of Stock of the Foreign Acquiring Corporation

Section 2.03(b) of the 2014 notice provides a rule concerning the interaction of §1.7874-5T and the EAG rules. Subject to two exceptions, the 2014 notice provides that certain stock, referred to as “transferred stock,” is not treated as held by a member

of the EAG for purposes of applying the EAG rules. As a result, transferred stock generally is included in both the numerator and the denominator of the ownership fraction. See §1.7874-5T(a). For this purpose, transferred stock is stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) that is received by a former domestic entity shareholder or former domestic entity partner that is a corporation (transferring corporation), and, in a transaction (or series of transactions) related to the domestic entity acquisition, is subsequently transferred.

The 2014 notice also described two exceptions to this rule: the U.S.-parented group exception and the foreign-parented group exception. When either of these exceptions applies, transferred stock is treated as held by members of the EAG for purposes of applying the EAG rules. In these cases, transferred stock is excluded from the numerator of the ownership fraction and, depending on the application of §1.7874-1(c), may be excluded from the denominator of the ownership fraction. See §1.7874-1(b) and (c).

The U.S.-parented group exception applies if: (i) before and after the domestic entity acquisition, the transferring corporation (or its successor) is a member of a U.S.-parented group, and (ii) after the domestic entity acquisition, both the person that holds the transferred stock after all related transfers of the transferred stock are complete and the foreign acquiring corporation are members of the U.S.-parented group referred to in (i).

The foreign-parented group exception applies if: (i) before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group, and (ii) after the domestic entity acquisition, the

transferring corporation is a member of the EAG, or would be a member of the EAG absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the foreign-parented group in a transaction related to the domestic entity acquisition (but taking into account all other transactions related to such acquisition).

The 2014 notice defines a U.S.-parented group as an affiliated group that has a domestic corporation as the common parent corporation, and a foreign-parented group as an affiliated group that has a foreign corporation as the common parent corporation. For this purpose, the term “affiliated group” means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting the term “more than 50 percent” for the term “at least 80 percent” each place it appears. Finally, the 2014 notice provides that, except as provided in the foreign-parented group exception, all transactions related to the domestic entity acquisition must be taken into account for purposes of determining an EAG, a U.S.-parented group, and a foreign-parented group.

### 3. Regulations Implementing the Rule

Section 1.7874-6T sets forth the rule concerning the interaction of §1.7874-5T and the EAG rules, as described in the 2014 notice, subject to the modifications described in this Part I.C.3, in part, to address comments received.

#### a. Loosening of the restrictions for the U.S.-parented group exception

In response to a comment, the Treasury Department and the IRS have determined that it is not necessary to limit the U.S.-parented group exception to cases in which the common parent after the domestic entity acquisition is the same as the common parent before the acquisition. Accordingly, under §1.7874-6T, the U.S.-

parented group exception applies if two requirements are satisfied. First, before the domestic entity acquisition, the transferring corporation must be a member of a U.S.-parented group. §1.7874-6T(c)(1)(i). Second, after the domestic entity acquisition, each of the transferring corporation (or its successor), any person that holds transferred stock, and the foreign acquiring corporation must be members of a U.S.-parented group the common parent of which: (i) before the domestic entity acquisition, was a member (including the parent) of the U.S.-parented group described in the first requirement; or (ii) is a corporation that was formed in a transaction related to the domestic entity acquisition, provided that, immediately after the corporation was formed (and without regard to any related transactions), the corporation was a member of the U.S.-parented group described in the first requirement. §1.7874-6T(c)(1)(ii).

A comment asserted that certain restructurings undertaken by foreign-parented groups could inappropriately be subject to section 7874. The comment posited a circumstance that is a variation of Example 2 of section 2.03(b)(iv) of the 2014 notice, where FA, the foreign acquiring corporation, acquired all the stock of a domestic corporation (DT) from a foreign corporation (FT) pursuant to a reorganization described in section 368(a)(1)(F). Related to the reorganization, FA subsequently issued shares to an individual in exchange for nonqualified property (as defined in §1.7874-4T(i)(7)), which prevented FA and FT from being members of the same expanded affiliated group, therefore resulting in an ownership fraction of 100 percent. The comment asserted that there was no policy reason for section 7874 to apply to this transaction and requested that all “foreign-to-foreign” reorganizations described in section 368(a)(1)(F) be excluded from the application of section 7874.

The Treasury Department and the IRS decline to adopt the comment at this time. Section 1.7874-6T addresses the interaction of §1.7874-5T and the EAG rules and, in particular, when transferred stock is treated as held by members of the EAG. In the example set forth in the comment, the stock that caused FA and FT to cease being members of the same EAG is not transferred stock. Thus, the comment is beyond the scope of the temporary regulations. Nevertheless, the Treasury Department and the IRS will continue to study the scope of section 7874 and its application to various transactions, including cases similar to the example set forth in the comment.

b. Identifying transferred stock

A comment noted that it is unclear how to identify transferred stock in certain cases. This may occur, for example, when a transferring corporation that receives stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) also holds other stock of the foreign acquiring corporation that has the same terms as the by-reason-of stock (other stock) (by-reason-of stock and other stock, collectively, fungible stock), and in a transaction related to the domestic entity acquisition, subsequently transfers less than all of the fungible stock. Different results would arise in these cases depending on the extent to which the subsequently transferred stock is considered to consist of by-reason-of stock or other stock.

To address this concern, the temporary regulations provide that a pro rata portion of the subsequently transferred stock is treated as consisting of by-reason-of stock.

See §1.7874-6T(f)(2)(ii).

c. Modifications to the affiliate-owned stock rules in §1.7874-1

The temporary regulations modify the affiliate-owned stock rules in §1.7874-1 to take into account the rules described in the 2014 notice. First, the temporary regulations provide that, subject to an exception, for purposes of §§1.7874-1 and 1.7874-1T, all transactions related to an acquisition are taken into account. See §1.7874-1T(f). This rule is consistent with the general rule provided in §1.7874-6T(e) and the general rule described in section 2.03(b)(i) of the 2014 notice.

Second, the temporary regulations modify the internal group restructuring exception to take into account §1.7874-6T(c)(2). See §1.7874-1T(c)(2)(iii).

#### D. The substantial business activities test

##### 1. The Subject-to-Tax Rule

Section 2.02(a) of the 2015 notice provides a rule (the subject-to-tax rule) that addresses domestic entity acquisitions in which a taxpayer asserts that its EAG has substantial business activities in the relevant foreign country when compared to the EAG's total business activities even though the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country. Under the subject-to-tax rule, an EAG cannot have substantial business activities in the relevant foreign country when compared to the EAG's total business activities unless the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.

The temporary regulations implement the subject-to-tax rule described in the 2015 notice without making any substantive changes. See §1.7874-3T(b)(4). The requirement set forth in §1.7874-3T(b)(4) is in addition to the three quantitative tests for group employees, group assets, and group income set forth in §1.7874-3(b)(1) through (3).

## 2. Clarification of “Group Income”

Under §1.7874-3, an EAG is considered to have substantial business activities in the relevant foreign country only if at least 25 percent of its group employees, group assets, and group income are located or derived in the relevant foreign country. In general, group income is gross income from transactions occurring in the ordinary course of business with unrelated customers, as determined consistently under either federal tax principles or as reflected in the EAG’s financial statements. With respect to group income determined using the EAG’s financial statements, a comment in response to final regulations issued under §1.7874-3 (see TD 9720, published on June 4, 2015, in the **Federal Register** (80 FR 31837)), questioned whether financial reporting principles apply only to determine the amount of items of income that is taken into account (such as where there is a book-tax difference) or also to determine which EAG members are to be taken into account during the testing period. The question arose because the regulations refer to the “International Financial Reporting Standards (IFRS) used for consolidated financial statement purposes.” §1.7874-3(d)(10). The reference in §1.7874-3(d)(10) to the IFRS used for consolidated financial statement purposes is intended to ensure only that the EAG uses a single set of IFRS in preparing financial statements for this purpose, as there may be certain variations in the IFRS used in different countries. The temporary regulations clarify that financial reporting principles are only relevant for determining the amount of items of income that are taken into account, as an EAG must take into account all items that its members (as determined based on the definition of EAG set forth in §1.7874-3(d)(4)) recognized for financial accounting purposes during the testing period.



## II. Rules Addressing Certain Post-Inversion Tax Avoidance Transactions

As stated in Section 1 of the 2014 notice, the Treasury Department and the IRS understand that certain inversion transactions are motivated in substantial part by the ability to engage in tax avoidance transactions after the inversion transaction that would not be possible in the absence of the inversion transaction. In order to reduce the tax benefits of certain post-inversion tax avoidance transactions, the 2014 notice announced that the Treasury Department and the IRS would issue regulations under sections 304(b)(5)(B), 367, 956(e), 7701(l), and 7874 of the Code. Furthermore, the 2015 notice announced additional rules to reduce the tax benefits of certain post-inversion tax avoidance transactions.

### A. United States property rule

#### 1. Overview

As described in section 3.01(a) of the 2014 notice, an inversion transaction may permit the new foreign parent of the inverted group, a group still principally comprised of United States shareholders and their CFCs, to avoid section 956 by accessing the untaxed earnings and profits of the CFCs without a current U.S. federal income tax to the United States shareholders. This is a result that the United States shareholders could not achieve before the inversion transaction. The ability of the new foreign parent to access deferred CFC earnings and profits would in many cases eliminate the need for the CFCs to pay dividends to the United States shareholders, thereby circumventing the purposes of section 956.

In order to prevent this avoidance of section 956, section 3.01(b) of the 2014 notice announces that future regulations will include a rule (the United States property

rule) providing that, solely for purposes of section 956, any obligation or stock of a non-CFC foreign related person (generally, either the foreign acquiring corporation or a foreign affiliate of the foreign acquiring corporation that is not an expatriated foreign subsidiary) is United States property within the meaning of section 956(c)(1) to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period. The 2014 notice defines an expatriated foreign subsidiary as a CFC with respect to which an expatriated entity is a United States shareholder, but provides that an expatriated foreign subsidiary does not include a CFC that is a member of the EAG on the completion date if the domestic entity is not a United States shareholder with respect to the CFC on or before the completion date. For example, a CFC owned by a U.S. corporation or U.S. partnership historically owned by the foreign parent generally would not be an expatriated foreign subsidiary because the domestic entity was not a United States shareholder with respect to such CFC on or before the completion date. See section 958(b)(4).

## 2. Regulations Implementing the United States Property Rule

These temporary regulations include the rules described in the 2014 notice, with certain modifications, in part, to address comments received.

### a. General section 956 rule

Section 1.956-2T(a)(4)(i) provides that, generally, for purposes of section 956 and §1.956-2(a), United States property includes an obligation of a foreign person and stock of a foreign corporation if (A) the obligation or stock is held by a CFC that is an expatriated foreign subsidiary, (B) the foreign person or foreign corporation is a non-CFC foreign related person, and (C) the obligation or stock was acquired either during

the applicable period or in a transaction related to the inversion transaction. A non-CFC foreign related person is defined as a foreign related person that is not itself an expatriated foreign subsidiary. See §1.7874-12T(a)(16). The rule applies to obligations and stock acquired during the applicable period or in a transaction related to the inversion transaction, regardless of whether at the time of acquisition the obligation or stock would constitute United States property—that is, regardless of whether, at the time of acquisition, the expatriated foreign subsidiary was a CFC or an expatriated foreign subsidiary, and the non-CFC foreign related person was a non-CFC foreign related person. Rather, the rules apply when the requirements set forth in §1.956-2T(a)(4)(i) are satisfied on the expatriated foreign subsidiary's relevant quarterly measuring date.

The Treasury Department and the IRS have determined that CFC acquisitions of stock or obligations of a prospective foreign acquiring corporation or its foreign affiliates in contemplation of an inversion transaction present the same repatriation concerns as such acquisitions undertaken after an inversion transaction. Accordingly, §1.956-2T(a)(4)(i)(C)(2) clarifies that stock or obligations that otherwise meet the requirements of the United States property rule described in the 2014 notice but that were issued prior to the applicable period, in a transaction related to the inversion transaction, constitute United States property, provided they are acquired on or after **April 4, 2016**.

An expatriated foreign subsidiary generally is defined as a CFC with respect to which an expatriated entity is a United States shareholder. See §1.7874-12T(a)(9)(i). However, consistent with the 2014 notice, the Treasury Department and the IRS have determined that the CFCs of a domestic subsidiary owned by a foreign acquiring

corporation before an inversion transaction should not be subject to the section 956 rules described in this Part II.A, or the rules under sections 7701(l) and 367(b) described in Sections B.1, B.2, and B.3 of this Part II. Accordingly, consistent with the 2014 notice, §1.7874-12T(a)(9)(ii) excludes from the definition of expatriated foreign subsidiary a CFC that was a member of the EAG on the completion date if the domestic entity was not a United States shareholder with respect to the CFC on or before the completion date. As a result of not being treated as expatriated foreign subsidiaries, these CFCs are not subject to the new rules described in this Part II.A. However, the stock and obligations of these CFCs generally are United States property when acquired by an expatriated foreign subsidiary during the applicable period because these CFCs constitute non-CFC foreign related persons within the meaning of these temporary regulations. In addition, the exclusion from the definition of expatriated foreign subsidiary does not apply to CFCs of the foreign acquiring corporation's legacy domestic group that are formed or acquired after the inversion transaction. See §1.956-2T(a)(4)(iv), Example 4.

The 2014 notice indicates that the term "expatriated entity" has the meaning provided in section 7874(a)(2)(A). Section 7874(a)(2)(A) defines an expatriated entity to include both the domestic entity and any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity. Comments questioned which entities are expatriated entities in certain cases, for example, when a domestic entity described in section 7874(a)(2)(B)(i) is transferred or ceases to exist. In response to these comments, these temporary regulations clarify that an expatriated entity means a domestic entity (which includes a successor to a domestic entity, whether domestic or

foreign) and any United States person that, on any date on or after the completion date, is or was related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity. See §1.7874-12T(a)(6) and (8). Thus, for example, an entity that is a domestic subsidiary of a foreign acquiring corporation on (and before) the completion date, is treated as an expatriated entity, while any CFCs owned by that domestic subsidiary on or before the completion date are not treated as expatriated foreign subsidiaries.

The 2014 notice also provides that an expatriated foreign subsidiary that is a pledgor or guarantor with respect to an obligation of a non-CFC foreign related person will be treated as holding the obligation, which would be United States property under the general rule of §1.956-2T(a)(4)(i), to the same extent that it would be treated as holding the obligation if it were a pledgor or guarantor with respect to an obligation of a United States person under the principles of section 956(d) and §1.956-2(c).

Accordingly, these temporary regulations add §1.956-2T(c)(5) to extend the pledge and guarantee rule in §1.956-2(c) to apply to obligations of non-CFC foreign related persons. Under this rule, an expatriated foreign subsidiary that is (or is treated as) a pledgor or guarantor of an obligation of a non-CFC foreign related person is considered to hold the obligation for purposes of section 956. In addition to pledges or guarantees entered into or treated as entered into during the applicable period, the rule applies to pledges or guarantees entered into or treated as entered into in a transaction related to an inversion transaction provided they are entered into or treated as entered into on or after **April 4, 2016**.

b. Exceptions from United States property

In the description of the United States property rule in section 3.01(b) of the 2014 notice, the Treasury Department and the IRS requested comments on whether any exceptions under section 956(c)(2) or §1.956-2 should apply to an obligation or stock of a non-CFC foreign related person that is United States property pursuant to the general rule in §1.956-2T(a)(4)(i). A comment suggested that the following exceptions from United States property should apply to obligations of non-CFC foreign related persons: (i) the exception for obligations arising out of the sale or processing of property described in section 956(c)(2)(C); (ii) the exception for assets equal to the earnings of the CFC that have been taxed as effectively connected with the conduct of a U.S. trade or business included in section 956(c)(2)(H); (iii) the exception for certain deposits made in the ordinary course of a person's business as a dealer in securities or commodities described in section 956(c)(2)(I); and (iv) the exception in section 956(c)(2)(J) for obligations, to the extent the principal amount thereof does not exceed the fair market value of readily marketable securities sold or repurchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a person that is a securities or commodities dealer.

The Treasury Department and the IRS have concluded that it is appropriate for these exceptions to apply to obligations of non-CFC foreign related persons as well as United States persons because they relate to ordinary business transactions. The exceptions in section 956(c)(2)(H) and (I) apply by their terms to obligations of non-CFC foreign related persons, and thus no rules need to be added to the regulations to extend their application. On the other hand, the exceptions in current section 956(c)(2)(C) and

(J) apply only to obligations of United States persons. Accordingly, these temporary regulations add rules in §1.956-2T(a)(4)(ii)(A) and (B), pursuant to which obligations of non-CFC foreign related persons are excluded from the definition of United States property to the same extent that obligations of United States persons are excluded from the definition of United States property under section 956(c)(2)(C) and (J). In addition, new §1.956-2T(d)(2)(iii) excludes from the definition of United States property obligations of non-CFC foreign related persons that arise in connection with the provision of services by a CFC, based on the principles of the exception in §1.956-2T(d)(2)(ii) (previously §1.956-2T(d)(2)(i)(B)), which sets forth a similar exclusion for obligations of United States persons.

A comment also advocated for an additional exception for CFCs that are regularly engaged in a third-party lending business. Specifically, the comment suggested that loans made by a CFC to related parties in the ordinary course of the CFC's business should not be treated as United States property when the CFC is regularly engaged in the business of making loans to unrelated parties. Alternatively, the comment suggested a more limited exclusion for loans made pursuant to a binding commitment that predated the inversion transaction, or negotiations leading to it, such as loans made under a revolving line of credit that was established several years before the first negotiations leading to the inversion transaction. An exception akin to the exception suggested by the comment does not currently exist with respect to obligations of United States persons. The consideration of new exceptions to the definition of United States property is beyond the scope of this regulation. Furthermore, the exception from the definition of non-CFC foreign related person for other expatriated

foreign subsidiaries ensures that CFCs of a newly inverted group that are in the business of lending to other CFCs of the group will not be subject to section 956 with respect to the loans.

The 2014 notice provides that the exception to the definition of obligation for certain short-term obligations announced in Notice 88-108 (the short-term obligation exception) would not apply to obligations of non-CFC foreign related persons. As discussed in more detail in Part III.B of this Explanation of Provisions section, Notice 88-108 announced an exception for obligations that are collected within 30 days, as long as the CFC does not have loans to related United States persons that would constitute United States property outstanding during the year for 60 or more days. A comment requested that the Treasury Department and the IRS reconsider this position because the concerns underlying the exception exist with respect to foreign-parented groups as well as U.S.-parented groups, and questioned the rationale for eliminating this exception in the context of an inversion transaction. The Treasury Department and the IRS are concerned that there is a heightened risk that taxpayers would take abusive positions in reliance on the short-term obligation exception announced in Notice 88-108 in post-inversion transaction structures, due to the fact that gaining access to the deferred foreign earnings of CFCs without paying U.S. federal income tax is often a stated goal of inversion transactions. Accordingly, these temporary regulations provide that the exception announced in Notice 88-108 applies only to obligations of United States persons. Therefore, this exception does not apply to an obligation of a non-CFC foreign related person that is treated as United States property pursuant to §1.956-2T(a)(4)(i).

B. Rules addressing avoidance of U.S. federal income tax on certain earnings and profits of a CFC or certain appreciation in a CFC's assets



## 1. Section 7701(l) Recharacterization Rule

### a. Overview

As described in the 2014 notice, after an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a CFC using certain transactions that do not give rise to U.S. federal income tax, so as to avoid U.S. federal income tax on the CFC's pre-inversion transaction earnings and profits. Additionally, even if the foreign acquiring corporation were to acquire less stock of an expatriated foreign subsidiary, such that the expatriated foreign subsidiary remained a CFC, it could nevertheless substantially dilute a United States shareholder's ownership of the CFC. As a result, the United States shareholder could avoid U.S. federal income tax on the CFC's pre-inversion transaction earnings and profits if, for example, the CFC later redeemed, on a non pro rata basis, its stock held by the foreign acquiring corporation.

In order to prevent the use of these transactions to avoid U.S. federal income tax, the 2014 notice announces that the Treasury Department and the IRS intend to issue regulations under section 7701(l) that will recharacterize specified transactions completed during the applicable period (the section 7701(l) recharacterization rule). A specified transaction is defined in section 3.02(e)(i) of the 2014 notice as a transaction in which stock in an expatriated foreign subsidiary (specified stock) is transferred (including by issuance) to a specified related person. A specified related person means a non-CFC foreign related person, a U.S. partnership that has one or more partners that is a non-CFC foreign related person, or a U.S. trust that has one or more beneficiaries that is a non-CFC foreign related person.

Section 3.02(e)(i)(A) of the 2014 notice provides that a specified transaction is recharacterized for all purposes of the Code, as of the date on which the specified transaction occurs, as an arrangement directly between the specified related person and one or more section 958(a) U.S. shareholders of the expatriated foreign subsidiary. A section 958(a) U.S. shareholder of an expatriated foreign subsidiary is defined in the 2014 notice as a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock in the expatriated foreign subsidiary, but only if the United States shareholder is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person.

The 2014 notice states that regulations will provide that, if an expatriated foreign subsidiary issues specified stock to a specified related person, the specified transaction will be recharacterized as follows: (i) the property transferred by the specified related person to acquire the specified stock (transferred property) will be treated as having been transferred by the specified related person to the section 958(a) U.S. shareholder(s) of the expatriated foreign subsidiary in exchange for instruments deemed issued by the section 958(a) U.S. shareholder(s) (deemed instrument(s)); and (ii) the transferred property or proportionate share thereof will be treated as having been contributed by the section 958(a) U.S. shareholder(s) (through intervening entities, if any, in exchange for equity in such entities) to the expatriated foreign subsidiary in exchange for stock in the expatriated foreign subsidiary. The 2014 notice states that similar principles will apply to recharacterize a specified transaction in which a

shareholder transfers specified stock of the expatriated foreign subsidiary to a specified related person (such as a partnership in which a non-CFC foreign related person is a partner).

Section 3.02(e)(i)(B) of the 2014 notice explains that regulations will provide that a deemed instrument treated as issued in a specified transaction will have the same terms as the specified stock (other than the issuer). Accordingly, if a distribution is made with respect to specified stock of the expatriated foreign subsidiary, matching seriatim distributions with respect to stock will be treated as made by the expatriated foreign subsidiary (through intervening entities, if any) to the section 958(a) U.S. shareholder(s). The section 958(a) U.S. shareholder(s), in turn, will be treated as making payments with respect to the deemed instrument(s) to the specified related person(s). An expatriated foreign subsidiary will be treated as the paying agent of a section 958(a) U.S. shareholder of the expatriated foreign subsidiary with respect to the deemed instrument treated as issued by the section 958(a) U.S. shareholder to a specified related person.

The 2014 notice states that the regulations will not recharacterize a specified transaction in certain situations. If the specified transaction is a fast-pay arrangement that is recharacterized under §1.7701(l)-3(c)(2), section 3.02(e)(i)(A) of the 2014 notice provides that the rules of §1.7701(l)-3 will apply instead of the recharacterization provided in the 2014 notice. Furthermore, section 3.02(e)(i)(C) of the 2014 notice provides that a specified transaction will not be recharacterized if the specified stock was transferred by a shareholder of the expatriated foreign subsidiary and, under applicable U.S. federal income tax rules, the shareholder either is required to recognize

and include in income all of the gain in the specified stock (including gain treated as a deemed dividend pursuant to section 964(e) or 1248(a) or characterized as a dividend pursuant to section 356(a)(2)) or has a deemed dividend included in income with respect to the specified stock under §1.367(b)-4 (including by reason of the regulations described in the 2014 notice that apply to specified exchanges, described in Section 2.c.i of this Part II.B). The last exception described in the 2014 notice applies if (i) the expatriated foreign subsidiary is a CFC immediately after the specified transaction and all related transactions, and (ii) the amount of stock (by value) in the expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) that is owned, in the aggregate, directly or indirectly by the section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction and any transactions related to the specified transaction does not decrease by more than 10 percent as a result of the specified transaction and any related transactions. The 2015 notice clarifies that the second prong of the exception is satisfied only if the percentage of stock (by value) (rather than the amount of stock (by value)) does not decrease by more than 10 percent.

Further, the 2014 notice states that regulations will provide that if a deemed dividend is included in a CFC's income under section 964(e) as a result of a specified transaction that is completed during the applicable period, the deemed dividend will not be excluded from foreign personal holding company income under section 954(c)(6) (to the extent in effect, and notwithstanding the rule described in Notice 2007-9, 2007-1 C.B. 401).

b. Regulations implementing the section 7701(l) recharacterization rule

These temporary regulations implement the section 7701(l) recharacterization rule described in the 2014 notice, subject to certain modifications, in part, to address comments received. Under §1.7701(l)-4T(b)(1), a specified transaction completed during the applicable period will be recharacterized in the manner described in §1.7701(l)-4T(c), subject to the exceptions described in §1.7701(l)-4T(b)(2).

i. General Recharacterization Rule

The description of the specified transaction rules in section 3.02(e) of the 2014 notice provides that a “section 958(a) U.S. shareholder” means any United States shareholder of an expatriated foreign subsidiary that is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person. In order to more appropriately tailor the rules, these temporary regulations narrow the definition of the term “section 958(a) U.S. shareholder” to include only United States shareholders that are expatriated entities. See §1.7701(l)-4T(f)(10).

If an expatriated foreign subsidiary issues specified stock to a specified related person, the specified transaction is recharacterized under §1.7701(l)-4T(c)(2) in the manner described in the 2014 notice. Similar rules are provided in §1.7701(l)-4T(c)(3) for a specified transaction arising from a transfer of specified stock by shareholders of the expatriated foreign subsidiary. In the 2014 notice, the Treasury Department and the IRS requested comments about the application of the recharacterization rules to transfers to partnerships that are specified related persons, as illustrated in Example 2 in section 3.02(e)(iii) of the notice. A comment suggested that the recharacterization described in the 2014 notice should not apply to transfers of specified stock to

partnerships, and that, instead, a transferee partnership should be treated as a conduit, to the extent of its ownership of specified stock and any corresponding property contributed to the partnership. The comment suggested that the section 958(a) U.S. shareholder could be treated as directly owning the specified stock, or, alternatively, the items attributable to the specified stock could be tracked solely to the section 958(a) U.S. shareholder. Thus, under the proposed recast, each transferor to the partnership would be treated as retaining its economic interest in the property transferred to the partnership.

The Treasury Department and the IRS appreciate the complexity of the recharacterization described in the 2014 notice, as highlighted by the comment, but are concerned that the comment does not fully account for the treatment of distributions by the expatriated foreign subsidiary as received by its section 958(a) U.S. shareholder rather than the transferee partnership. After consideration of the comment's proposal, the Treasury Department and the IRS have determined that the recharacterization described in the 2014 notice better ensures that an expatriated foreign subsidiary that is transferred to a partnership that is a specified related person continues to be a CFC, while addressing the ancillary consequences of recharacterizing the transfer.

The expatriated foreign subsidiary stock that is deemed issued pursuant to the recharacterization is referred to in the regulations as "deemed issued stock," and the specified stock actually issued pursuant to the specified transaction but disregarded pursuant to the recharacterization is referred to as "disregarded specified stock." Because the instruments deemed issued by a section 958(a) U.S. shareholder have the same terms as the disregarded specified stock (other than the issuer), the Treasury

Department and the IRS believe that the deemed instruments generally will be treated as equity for all purposes of the Code.

ii. Exceptions from Recharacterization

Section 1.7701(l)-4T(b)(2) sets forth three exceptions to the application of the rules in §1.7701(l)-4T(c) to recharacterize a specified transaction. The first two exceptions are consistent with the exceptions described in the 2014 notice and the 2015 notice for fast-pay arrangements described in §1.7701(l)-3(b) and transactions (including specified exchanges) in which an appropriate amount of gain is recognized. See Section 2.C of this Part II.B for a description of the rules applicable to specified exchanges.

The final exception applies when the expatriated foreign subsidiary is a CFC immediately after the specified transaction and any related transaction and there is only a de minimis shift of ownership of the stock of the expatriated foreign subsidiary or any lower-tier expatriated foreign subsidiary to non-CFC foreign related persons. See §1.7701(l)-4T(b)(2)(iii). This exception (referred to in this Part II.B.1.b.ii as the “de minimis exception”) replaces the exception described in the 2014 notice for specified transactions in which the ownership of section 958(a) U.S. shareholders did not decrease by more than 10 percent as a result of the specified transaction and any related transactions. The new de minimis exception better reflects the policy behind the section 7701(l) recharacterization rule by ensuring that dilution of the ownership interests of section 958(a) U.S. shareholders in an expatriated foreign subsidiary that is attributable to unrelated persons is not taken into account in determining whether the exception from recharacterization applies. See §1.7701(l)-4T(g), Example 3.

The de minimis exception generally determines whether a specified transaction shifts ownership of stock of an expatriated foreign subsidiary (or any lower-tier expatriated foreign subsidiary) to non-CFC foreign related persons by comparing the percentage of the stock (by value) of the expatriated foreign subsidiary (or any lower-tier expatriated foreign subsidiary) owned immediately before and immediately after the transaction by persons other than non-CFC foreign related persons. For this purpose, to determine direct or indirect ownership, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or domestic. §1.7701(l)-4T(f)(4). The de minimis exception applies if the post-transaction ownership percentage (defined in §1.7701(l)-4T(f)(9)) is at least 90 percent of the pre-transaction ownership percentage (defined in §1.7701(l)-4T(f)(8)).

The temporary regulations provide a special rule to ensure that stock of a corporation that is directly or indirectly owned by a domestic corporation that is an expatriated entity is considered for purposes of the de minimis exception as not owned by a non-CFC foreign related person. See §1.7701(l)-4T(f)(4). Absent this special rule, such stock would not, to the extent such stock is indirectly owned by a non-CFC foreign related person through the domestic corporation, be treated as owned by a person other than a non-CFC foreign related person for purposes of the de minimis exception.

Because the de minimis exception measures the shift in ownership of lower-tier expatriated foreign subsidiaries as well as the expatriated foreign subsidiary whose stock is transferred or issued in the specified transaction, dilution of a United States person's indirect interest in a lower-tier expatriated foreign subsidiary can prevent the exception from applying, even if the United States person is not a section 958(a) U.S.



shareholder with respect to that lower-tier expatriated foreign subsidiary. See §1.7701(l)-4T(g), Example 6.

The 2014 notice requested comments on whether an exception to the section 7701(l) recharacterization rule and the section 367(b) stock dilution rule (described in Section 2 of this Part II.B) is warranted where (i) a specified transaction is undertaken in order to integrate similar or complementary businesses and (ii) after the inversion transaction, the inverted group in fact does not exploit that form in order to avoid U.S. taxation on the expatriated foreign subsidiary's pre-inversion earnings and profits. In addition, the 2014 notice requested comments on the provisions that would be necessary to administer such an exception and on the types of transactions that would need to serve as "triggers" for denying the exception because taxpayers could use them to avoid tax on a CFC's pre-inversion earnings after a specified transaction. One comment recommended providing a business integration exception because foreign-parented multinational groups of corporations often engage in internal restructurings for business reasons. After consideration of the comment, the Treasury Department and the IRS have determined that a business integration exception would be very difficult to administer given the subjective nature of the determination, the difficulty of determining whether the taxpayer takes "exploitative" actions in subsequent taxable years, and the complexity of potentially having to apply the section 7701(l) recharacterization rule retroactively depending on these subsequent actions. Accordingly, the temporary regulations do not provide a business integration exception.

iii. Transactions Affecting Ownership of Stock of an Expatriated Foreign Subsidiary Following a Recharacterized Specified Transaction

The rules in §1.7701(l)-4T(d) address transactions that affect the ownership of stock of an expatriated foreign subsidiary after a specified transaction with respect to the expatriated foreign subsidiary has been recharacterized under §1.7701(l)-4T(c)(2) or (3). As discussed in Section i of this Part II.B.1.b, a specified transaction that is recharacterized under the rules of §1.7701(l)-4T(c) is recharacterized for all purposes of the Code as of the date that the specified transaction occurs. Although the recharacterization described in the 2014 notice generally applies for all purposes for all future tax years, the Treasury Department and the IRS considered whether to unwind the recharacterization when stock, including disregarded specified stock, in the expatriated foreign subsidiary is transferred (directly or indirectly) after the specified transaction, and considered adding other special rules concerning the results of a subsequent transfer of expatriated foreign subsidiary stock.

The specified transaction rules in §1.7701(l)-4T are issued under the Secretary's regulatory authority in section 7701(l) to recharacterize multi-party financing arrangements to prevent the avoidance of tax, which is the same authority underlying the fast-pay arrangement rules in §1.7701(l)-3. Although the two regulations serve a similar purpose, the technical rules that effectuate that purpose deviate due to differences in the underlying financing arrangements. The specified transaction rules set forth herein generally are concerned with the relationship of the expatriated foreign subsidiary to the expatriated entity, as well as the expatriated foreign subsidiary's status as a controlled foreign corporation, and thus generally are focused on abusive transactions that affect the direct and indirect ownership of the expatriated foreign subsidiary.

The 2014 notice states that rules similar to those described in §1.7701(l)-3(c)(3)(iii) (concerning transfers of benefited stock) under the fast-pay regulations will apply to transactions affecting specified stock. In general, pursuant to §1.7701(l)-3(c)(3)(iii)(A), the designation of stock as benefited stock continues upon transfer of the stock. Upon further consideration, the Treasury Department and the IRS have determined that it is not necessary for the specified transaction rules to maintain the connection between the instruments that are deemed issued pursuant to the recharacterization and the stock (specifically, the non-specified stock) that led to the application of the recharacterization rules, as occurs when §1.7701(l)-3(c)(3)(iii) is applied to fast-pay stock, due to the differences in policy underlying the fast-pay regulations and these temporary regulations. Accordingly, a transfer of non-specified stock does not require an associated transfer of the deemed instruments as would be required under the rules in §1.7701(l)-3(c)(3)(iii) for a transfer of benefited stock. See §1.7701(l)-4T(d)(1).

However, the Treasury Department and the IRS determined that special rules are necessary to address direct and indirect transfers of stock of an expatriated foreign subsidiary (both disregarded specified stock and non-specified stock), including rules that generally terminate the recharacterization provided for in these temporary regulations. Transactions that occur after the specified transaction can affect the underlying ownership of the expatriated foreign subsidiary stock in such a way that the underlying need for the recharacterization rules ceases to exist. That is, there is no reason for the recharacterization rules to continue to apply when the reason for the rule ceases to apply; the rules need to apply only to the extent the relatedness that gave rise

to the application of the rules continues to be present. In addition, transactions in which the inverted group no longer holds the expatriated foreign subsidiary create concerns about whether the taxpayer will have access to the information necessary to comply with the rules in these temporary regulations. In this circumstance, the administrative burden of maintaining the recharacterization is not justified.

Thus, the Treasury Department and the IRS have determined that it is appropriate, in certain circumstances, to unwind the recharacterization as a result of certain subsequent transactions that affect the ownership of the expatriated foreign subsidiary. The regulations provide that the recharacterization generally is fully unwound when an expatriated foreign subsidiary ceases to be a foreign related person. Specifically, §1.7701(l)-4T(d)(2) provides that when a transaction causes an expatriated foreign subsidiary to cease to be a foreign related person, the recharacterization is fully unwound immediately before the transaction as follows: the section 958(a) U.S. shareholders are treated as redeeming their respective deemed instruments with the deemed issued stock in the expatriated foreign subsidiary, which, in turn, is “recapitalized” into the disregarded specified stock (which is the specified stock that was transferred in the specified transaction that gave rise to the application of §1.7701-4T) in the hands of the specified related person.

In addition, the regulations provide for a similar pro-rata unwind when the expatriated foreign subsidiary continues to be a foreign related person after a direct or indirect transfer of disregarded specified stock of the expatriated foreign subsidiary, and, after the transfer, no portion of the disregarded specified stock is held by a foreign related person, a specified related person, or an expatriated entity. In such

circumstances, §1.7701(l)-4T(d)(3) provides that the recharacterization under §1.7701(l)-4T(c)(2) or (3) is partially unwound as follows: the section 958(a) U.S. shareholders are treated as redeeming a proportionate amount of their respective deemed instruments with the deemed issued stock in the expatriated foreign subsidiary, which, in turn, is “recapitalized” into the disregarded specified stock (which is the specified stock that was transferred in the specified transaction that gave rise to the application of §1.7701-4T) in the hands of the specified related person.

The regulations also provide a rule that applies when there is a direct transfer of disregarded specified stock, but the recharacterization is not unwound, because the transaction does not result in an unwind under the rules described earlier in this Part II.B.1.b.iii. In those circumstances, the transferor is treated as transferring the deemed instruments, in lieu of the disregarded specified stock, in exchange for the consideration that was received in exchange for the disregarded specified stock. See §1.7701(l)-4T(d)(4).

Even if the rules described in this Part II.B.1.b.iii do not apply to unwind a recharacterization under the rules of §1.7701(l)-4T(c)(2) or (3), an inverted group may choose to unwind the recharacterization by causing the expatriated foreign subsidiary to actually redeem all of its disregarded specified stock.

#### iv. Treatment of Deemed Dividends Included in Income under Section 964(e)

Under §1.7701(l)-4T(e), and consistent with section 3.02(e)(i) of the 2014 notice, a deemed dividend that is included in a CFC's income under section 964(e) as a result of a specified transaction that is completed during the applicable period is not excluded from FPHCI under section 954(c)(6) (to the extent in effect and notwithstanding the rule

described in Notice 2007-9). See Part III.C of this Explanation of Provisions section for a discussion of Notice 2007-9.

## 2. Section 367(b) Stock Dilution Rule

### a. Overview

Section 3.02(e)(ii) of the 2014 notice provides a rule (the section 367(b) stock dilution rule) that addresses certain post-inversion transaction exchanges that dilute the interest of a United States shareholder in a CFC and, absent the rule, could allow the United States shareholder to avoid U.S. federal income tax on earnings and profits of the CFC that exist at the time of the exchange. Specifically, the section 367(b) stock dilution rule, as described in the 2014 notice, provides that when certain requirements are satisfied with respect to an exchange (see Section c.i of this Part II.B.2), the exchanging shareholder is generally required to include in income as a deemed dividend the section 1248 amount with respect to the stock exchanged.

As explained in the 2014 notice, the section 367(b) stock dilution rule is subject to an exception. The exception applies to exchanges that satisfy the principles of the second exception described in section 3.02(e)(i)(C) of the 2014 notice (regarding specified transactions that do not decrease, in the aggregate, the section 958(a) U.S. shareholders' ownership of stock in an expatriated foreign subsidiary (or lower-tier expatriated foreign subsidiary) by more than 10 percent).

The 2014 notice also provides that §1.367(b)-4(c)(1) (regarding the exclusion of a deemed dividend from foreign personal holding company income) does not apply to a deemed dividend that results from an exchange to which the section 367(b) stock dilution rule applies. Further, the 2014 notice provides that such a deemed dividend

does not qualify for the exceptions from foreign personal holding company income provided by section 954(c)(3)(A)(i) or (6) (to the extent in effect).

b. Application of the section 367(b) stock dilution rule to unrealized appreciation

The 2015 notice expands the consequences of being subject to the section 367(b) stock dilution rule. The 2015 notice provides that, when an exchanging shareholder is required under the section 367(b) stock dilution rule to include in income as a deemed dividend the section 1248 amount (if any) with respect to the stock exchanged, the exchanging shareholder must also, after taking into account any increase in basis provided in §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend, recognize all realized gain with respect to the stock that is not otherwise recognized. The 2015 notice explains that this result is necessary to prevent a United States shareholder of a CFC from potentially avoiding U.S. federal income tax on net unrealized built-in-gain in property held by the CFC at the time of the exchange of the stock of the CFC. See section 3.02(b) of the 2015 notice.

The 2015 notice also states that a conforming change will be made to the regulations described in section 3.02(e)(i) of the 2014 notice. Thus, as noted in Section 1.b.ii of this Part II.B, the first exception described in section 3.02(e)(i)(C) of the 2014 notice applies with respect to a transfer of specified stock only if, as a result of the transfer, all the gain in the specified stock is recognized.

c. Regulations implementing the section 367(b) stock dilution rule

The temporary regulations implement the section 367(b) stock dilution rule as described in the 2014 notice and the 2015 notice, subject to certain modifications. See §1.367(b)-4T(e).

i. Requirements for the Section 367(b) Stock Dilution Rule to Apply

The section 367(b) stock dilution rule, as described in the 2014 notice, generally applies to an exchange when three requirements are satisfied. First, the exchanging shareholder must be described in §1.367(b)-4(b)(1)(i)(A). Second, the exchange must occur pursuant to a transaction described in §1.367(b)-4(a) in which the exchanging shareholder exchanges stock of an expatriated foreign subsidiary for stock in another foreign corporation. And third, the exchange must occur within the applicable period. The temporary regulations, as well as the remainder of this preamble, use the term “specified exchange” to describe any exchange that meets all three requirements and with respect to which the section 367(b) stock dilution rule thus generally applies. See §1.367(b)-4T(e)(1) and (2).

ii. Exceptions to Section 367(b) Stock Dilution Rule

The Treasury Department and the IRS have determined that it is appropriate to provide two new exceptions to the section 367(b) stock dilution rule. The first exception applies to specified exchanges in which the exchanging shareholder is neither an expatriated entity nor an expatriated foreign subsidiary. The temporary regulations incorporate this exception into the first requirement for an exchange to be a specified exchange. See §1.367(b)-4T(e)(2)(i) (requiring, among other things, that the exchanging shareholder be an expatriated entity or an expatriated foreign subsidiary).

The second exception replaces the exception described in the 2014 notice, and is consistent with the exception for de minimis shifts in ownership provided in §1.7701(l)-4T(b)(2)(iii) and discussed in Section 1.b.ii of this Part II.B. Accordingly, the second exception applies to specified exchanges when the expatriated foreign



subsidiary is a CFC immediately after the specified exchange and there is only a de minimis shift of ownership of the stock of the acquired expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) to non-CFC foreign related persons. See §1.367(b)-4T(e)(3).

Under the second exception, as in the de minimis exception with respect to the section 7701(l) recharacterization rule provided in §1.7701(l)-4T(b)(2)(iii), to determine whether a specified exchange shifts ownership of stock of an acquired expatriated foreign subsidiary (or any lower-tier expatriated foreign subsidiary) to non-CFC foreign related persons, the temporary regulations generally compare the percentage of the stock (by value) of the corporation owned immediately before and immediately after the exchange by persons other than non-CFC foreign related persons. In the case of asset acquisitions, however, because the acquired expatriated foreign subsidiary does not exist after the exchange, the temporary regulations compare (i) the percentage of the stock (by value) of the transferee foreign corporation—which may be viewed as a successor of the acquired expatriated foreign subsidiary for purposes of the exception—owned immediately after the exchange by persons other than non-CFC foreign related persons to (ii) the percentage of the stock (by value) of the acquired expatriated foreign subsidiary owned immediately before the exchange by persons other than non-CFC foreign related persons. The rules concerning the determination of indirect ownership for this purpose are identical to those applicable for purposes of the de minimis exception from the section 7701(l) recharacterization rule, described in Section 1.b.ii of this Part II.B.

Further, as is generally the case throughout §1.367(b)-4, judicial doctrines and principles, such as substance-over-form and the step-transaction doctrine, apply in determining whether the requirements of a specified exchange or the de minimis exception are satisfied. See also Rev. Rul. 83-23, 1983-1 C.B. 82.

As noted in Section 1.b.ii of this Part II.B, the 2014 notice requested comments on whether an exception to the section 7701(l) recharacterization rule discussed therein and the section 367(b) stock dilution rule is warranted for certain business integration transactions. For the reasons discussed with respect to the section 7701(l) recharacterization rule, the temporary regulations do not provide a business integration exception with respect to the section 367(b) stock dilution rule.

### iii. Treatment of Income Inclusions under Section 367(b)

Consistent with section 3.02(e)(ii) of the 2014 notice, §1.367(b)-4T(e)(4) provides that an income inclusion of a foreign corporation under §1.367(b)-4T(e)(1) does not qualify for the exceptions from foreign personal holding company income provided by sections 954(c)(3)(A)(i) and 954(c)(6) (to the extent in effect and notwithstanding the rule described in Notice 2007-9). See Part III.C of this Explanation of Provisions section for a discussion of Notice 2007-9.

## 3. Section 367(b) Asset Dilution Rule

### a. Transactions at issue

For reasons similar to those discussed in section 3.02(d) of the 2014 notice and section 3.02(b) of the 2015 notice, the Treasury Department and the IRS have determined that, upon a transfer by an expatriated foreign subsidiary of property (other than stock of another expatriated foreign subsidiary) to a transferee foreign corporation

in certain section 351 exchanges, the expatriated foreign subsidiary should be required to recognize all realized gain in the property that is not otherwise recognized. Absent such a rule, the transfer could dilute a United States shareholder's indirect interest in the property and, as a result, could allow the United States shareholder to avoid U.S. federal income tax on realized gain that is not recognized at the time of the transfer. For example, under section 351, an expatriated foreign subsidiary could transfer appreciated intangible property to a transferee foreign corporation in connection with a transfer by a non-CFC foreign related person to the transferee foreign corporation. Realized gain in the transferred property that is not recognized at the time of the transfer would, when recognized by the transferee foreign corporation after the transfer, create earnings and profits that are attributable to gain that economically had accrued within the U.S. federal income tax system at the time of the transfer. Because the United States shareholder would own less than all the stock of the transferee foreign corporation, the United States shareholder could avoid U.S. federal income tax on such earnings and profits, particularly if the transferee foreign corporation is not a CFC.

b. Regulations implementing the section 367(b) asset dilution rule

The temporary regulations provide a rule (the section 367(b) asset dilution rule) that applies when an expatriated foreign subsidiary transfers specified property to a foreign transferee corporation in an exchange described in section 351 that occurs within the applicable period. §1.367(b)-4T(f)(1). When the section 367(b) asset dilution rule applies, the expatriated foreign subsidiary must recognize all realized gain (but not loss) with respect to the specified property that is not otherwise recognized, unless an exception applies. §1.367(b)-4T(f)(1). For this purpose, specified property means any

property other than stock of a lower-tier expatriated foreign subsidiary. §1.367(b)-4T(g)(5).

Similar to the section 367(b) stock dilution rule, the section 367(b) asset dilution rule contains an exception that applies to transfers in which there is only a de minimis shift of ownership of the specified property to non-CFC foreign related persons. See §1.367(b)-4T(f)(2). For purposes of the exception, the temporary regulations use ownership of stock of the expatriated foreign subsidiary immediately before the exchange as a proxy for ownership of specified property immediately before the exchange, and, similarly, use ownership of stock of the transferee foreign corporation immediately after the exchange as a proxy for ownership of specified property immediately after the exchange.

#### 4. The Section 304 Rules

##### a. Transactions at issue

Section 3.03(b) of the 2014 notice explains how taxpayers may be engaging in certain transactions following an inversion transaction that reduce the earnings and profits of a CFC to facilitate repatriation of cash and other property of the CFC. The Treasury Department and the IRS understand that taxpayers may interpret section 304(b)(5)(B) to not apply when more than 50 percent of the dividend arising upon application of section 304 is sourced from the domestic corporation, even though, for example, pursuant to an income tax treaty there may be no (or a reduced rate of) U.S. withholding tax imposed on a dividend sourced from the domestic corporation. Under this position, the dividend sourced from earnings and profits of the CFC would never be subject to U.S. federal income tax.

## b. Overview

To address the concerns described in Section a of this Part II.B.4, section 3.03(b) of the 2014 notice provides rules (the section 304 rules) that apply for purposes of section 304(b)(5)(B). In particular, the section 304 rules provide that the determination of whether more than 50 percent of the dividends that arise under section 304(b)(2) is subject to tax or includible in the earnings and profits of a CFC is made by taking into account only the earnings and profits of the acquiring corporation (and therefore excluding the earnings and profits of the issuing corporation). The section 304 rules also provide that if a partnership, option (or similar interest), or other arrangement, is used with a principal purpose of avoiding the application of the rule described in section 3.03(b) of the 2014 notice (for example, to treat a transferor as a CFC), then the partnership, option (or similar interest), or other arrangement will be disregarded for purposes of applying the rule. Further, the section 304 rules provide that these rules apply without regard to whether an inversion transaction has occurred.

## c. Regulations implementing the section 304 rules

Section 1.304-7T sets forth regulations implementing the section 304 rules as described in the 2014 notice.

A comment requested that the regulations clarify that a dividend is “subject to tax” if it is reportable in the income of a U.S. person, even if that income is not currently burdened with tax because of the U.S. person’s tax attributes. The Treasury Department and the IRS decline to adopt the comment at this time because the narrow scope of §1.304-7T concerns taking into account only the earnings and profits of the

acquiring corporation, for purposes of making the 50 percent determination discussed in Section b of this Part II.B.4.

### C. Inversion gain rule

#### 1. In General

Section 7874(a)(1), together with section 7874(e)(1) (which prevents the use of certain credits to offset U.S. federal income tax on inversion gain), ensures that an expatriated entity generally pays current U.S. federal income tax with respect to inversion gain. These rules are intended to ensure that an appropriate “toll charge” is paid on transactions that accompany or follow an inversion transaction and are designed to “remove income from foreign operations from the U.S. taxing jurisdiction.” See H.R. Conf. Rep. No. 755, at 568, 574 (2004); JCT Explanation, at 342, 345.

Section 3.01(b) of the 2015 notice announces that the Treasury Department and the IRS intend to issue regulations that will provide a rule (the inversion gain rule) to address certain indirect transfers by an expatriated entity that, absent the rule, could have the effect of removing foreign earnings from the U.S. taxing jurisdiction while avoiding current U.S. federal income tax. As described in the 2015 notice, the inversion gain rule provides that inversion gain includes income or gain recognized by an expatriated entity from an indirect transfer or license of property, such as an expatriated entity’s section 951(a)(1)(A) gross income inclusions taken into account during the applicable period that are attributable to a transfer of stock or other properties or a license of property, either: (i) as part of the acquisition, or (ii) after such acquisition if the transfer or license is to a specified related person. However, clause (ii) of the preceding

sentence generally does not apply to transfers or licenses of property that is inventory in the hands of the transferor or licensor.

The inversion gain rule also provides that, if a partnership that is a foreign related person transfers or licenses property, a partner of the partnership is treated as having transferred or licensed its proportionate share of that property, as determined under the rules and principles of sections 701 through 777, for purposes of determining inversion gain.

## 2. Regulations Implementing the Inversion Gain Rule

Section 1.7874-11T sets forth the inversion gain rule as described in the 2015 notice, subject to the following modification. In response to a comment, §1.7874-11T(b)(1) provides that inversion gain includes amounts treated as a dividend under section 78 with respect to foreign taxes deemed to be paid by an expatriated entity under section 902(a) or 960(a)(1).

### III. Miscellaneous Rules and Comment Request

#### A. New definitions section in section 7874 regulations

As noted in Part I of the Background section of this preamble, the temporary regulations provide a new definitions section, §1.7874-12T, that defines certain terms commonly used in §§1.367(b)-4T, 1.956-2T, 1.7701(l)-4T, 1.7874-2, 1.7874-2T, and 1.7874-6T through 1.7874-11T. The Treasury Department and the IRS anticipate, in the future, updating other portions of the section 7874 regulations to conform those sections with the nomenclature used in §1.7874-12T.

A comment noted that certain rules in the 2014 notice apply to inversion transactions, defined as acquisitions in which the foreign acquiring corporation is treated

as a surrogate foreign corporation under section 7874(a)(2). The comment further noted that a transaction is not an inversion transaction if the substantial business activities requirement in section 7874(a)(2)(B)(iii) is not satisfied, but requested that this point be clarified in regulations.

The Treasury Department and the IRS believe that the definition of an inversion transaction, defined in the temporary regulations as a domestic entity acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), taking into account section 7874(a)(3), is clear. If the substantial business activities requirement in section 7874(a)(2)(B)(iii) is not satisfied, the foreign acquiring corporation is not a surrogate foreign corporation, and the acquisition therefore is not an inversion transaction. Accordingly, this comment is not adopted.

**B. Rules under section 956 relating to the definition of obligation announced in Notice 88-108, Notice 2008-91, Notice 2009-10, and Notice 2010-12**

On September 16, 1988, the Treasury Department and the IRS issued Notice 88-108, which announced that regulations would be issued under section 956 that would exclude from the definition of the term “obligation” for purposes of section 956 obligations that are collected within 30 days, as long as the CFC does not have loans to related United States persons that would constitute United States property outstanding during the year for 60 or more days (the 30/60 day exception). Due to circumstances affecting liquidity in the United States during 2008, on October 4, 2008, the Treasury Department and the IRS issued Notice 2008-91, which announced that the 30/60 day exception would be expanded to exclude obligations that are collected within 60 days, as long as the CFC does not have loans outstanding to related United States persons



that would constitute United States property during the year for 180 or more days (the 60/180 day exception). A CFC could choose to apply either the 30/60 day exception or the 60/180 day exception in years in which the 60/180 day exception is applicable. Notice 2008-91 applies for the first two taxable years of a foreign corporation ending after October 3, 2008, but does not apply to taxable years of a foreign corporation beginning after December 31, 2009. On January 14, 2009, the Treasury Department and the IRS issued Notice 2009-10, which extends the application of the regulations described in Notice 2008-91 to a third taxable year in certain cases. On December 28, 2009, the Treasury Department and the IRS issued Notice 2010-12, which extends the application of Notice 2008-91 to the taxable year of the CFC that immediately follows the last taxable year of the CFC to which the regulations described in Notice 2008-91 otherwise could apply.

These temporary regulations set forth the exceptions to the definition of obligation that were announced in Notice 88-108 and Notice 2008-91, as modified by Notice 2009-10 and Notice 2010-12. Section 1.956-2T(d)(2)(iv) provides the short-term obligation exception described in Notice 88-108, and §1.956-2T(d)(2)(v) provides the alternative short-term obligation exception described in Notice 2008-91, Notice 2009-10 and Notice 2010-12. For the years in which §1.956-2T(d)(2)(v) is applicable, CFCs can choose to apply either paragraph (iv) or paragraph (v) of §1.956-2T(d)(2).

As noted in Part II.A.2.b of this Explanation of Provisions section, the exceptions in §1.956-2T(d)(2)(iv) and (v) apply only to obligations of United States persons, and thus do not apply to an obligation of a non-CFC foreign related person that is treated as United States property pursuant to §1.956-2T(a)(4)(i).

The rules in §1.956-2T(d)(2)(iv) described in this Part III.B that were described in Notice 88-108 apply to obligations held on or after September 16, 1988, and the rules in §1.956-2T(d)(2)(v) apply to the first three taxable years of a foreign corporation ending after October 3, 2008, other than taxable years of a foreign corporation beginning on or after January 1, 2011, as well as the fourth taxable year of a foreign corporation, if any, when the foreign corporation's third taxable year (including any short taxable year) ended after October 3, 2008, and on or before December 31, 2009.

C. Request for comments with respect to rules under section 954(c)(6) announced in Notice 2007-9 affected by the 2014 notice

On January 11, 2007, the Treasury Department and the IRS issued Notice 2007-9, which provided guidance under section 954(c)(6) and announced that regulations under section 954(c)(6) that incorporated the guidance provided in the notice would be issued. In particular, Notice 2007-9 announced that gains treated as dividends under section 964(e) would be included among dividends eligible for the exclusion from FPHCI in section 954(c)(6). In the 2014 notice, the Treasury Department and the IRS announced that, notwithstanding Notice 2007-9, a deemed dividend included in a CFC's income under section 964(e) as a result of a specified exchange or a specified transaction that is completed during the applicable period would not be excluded from FPHCI under section 954(c)(6). As noted in Parts II.B.1.b.iv and II.B.2.c.iii of this Explanation of Provisions section, §§1.367(b)-4T(e)(4) and 1.7701(l)-4T(e) set forth the limitations on the applicability of section 954(c)(6) described in the 2014 notice. The Treasury Department and the IRS request comments as to whether it is appropriate to treat other amounts included by a CFC in gross income as a dividend under section 964(e) as dividends from a related person to which section 954(c)(6) may apply.

## **Effect on Other Documents**

Notice 88-108, 1988-2 C.B. 446 is obsolete as of **April 4, 2016**.

Notice 2008-91, 2008-43 I.R.B. 1001 is obsolete as of **April 4, 2016**.

Notice 2009-10, 2009-5 I.R.B. 419 is obsolete as of **April 4, 2016**.

Notice 2010-12, 2010-4 I.R.B. 326 is obsolete as of **April 4, 2016**.

Notice 2014-52, 2014-42 I.R.B. 712 is obsolete as of **April 4, 2016**.

Notice 2015-79, 2015-49 I.R.B. 775 is obsolete as of **April 4, 2016**.

## **Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

## **Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It has been determined that sections 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) do not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the cross-referenced notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## **Drafting Information**

The principal authors of these regulations are Rose E. Jenkins, David A. Levine, and Shane M. McCarrick of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

## **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

## **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.367(b)-4T and adding the following entries in numerical order to read in part as follows:

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

Section 1.304-7T also issued under 26 U.S.C. 304(b)(5)(C).

\* \* \* \* \*

Section 1.367(b)-4T also issued under 26 U.S.C. 367(b) and 954(c)(6)(A).

\* \* \* \* \*

Section 1.956-2T also issued under 26 U.S.C. 956(d) and 956(e).

\* \* \* \* \*

Section 1.7701(l)-4T also issued under 26 U.S.C. 7701(l) and 954(c)(6)(A).

\* \* \* \* \*

Section 1.7874-2T also issued under 26 U.S.C. 7874(c)(6) and (g).

\* \* \* \* \*

Section 1.7874-3T also issued under 26 U.S.C. 7874(c)(6) and (g).

\* \* \* \* \*

Section 1.7874-6T also issued under 26 U.S.C. 7874(c)(6) and (g).  
Section 1.7874-7T also issued under 26 U.S.C. 7874(c)(6) and (g).  
Section 1.7874-8T also issued under 26 U.S.C. 7874(c)(6) and (g).  
Section 1.7874-9T also issued under 26 U.S.C. 7874(c)(6) and (g).  
Section 1.7874-10T also issued under 26 U.S.C. 7874(c)(4) and (g).  
Section 1.7874-11T also issued under 26 U.S.C. 7874(g).  
Section 1.7874-12T also issued under 26 U.S.C. 7874(g).

Par. 2. Section 1.304-6 is added to read as follows:

§1.304-6 Amount constituting a dividend. [Reserved]

Par. 3. Section 1.304-7T is added to read as follows:

§1.304-7T Certain acquisitions by foreign acquiring corporations (temporary).

(a) Scope. This section provides rules regarding the application of section 304(b)(5)(B) to an acquisition of stock described in section 304 by an acquiring corporation that is foreign (foreign acquiring corporation). Paragraph (b) of this section provides the rule for determining which earnings and profits are taken into account for purposes of applying section 304(b)(5)(B). Paragraph (c) of this section provides rules addressing the use of a partnership, option (or similar interest), or other arrangement. Paragraph (d) of this section provides examples that illustrate the rules of this section. Paragraph (e) of this section provides the applicability date, and paragraph (f) of this section provides the date of expiration.

(b) Earnings and profits taken into account. For purposes of applying section 304(b)(5)(B), only the earnings and profits of the foreign acquiring corporation are taken into account in determining whether more than 50 percent of the dividends arising from

the acquisition (determined without regard to section 304(b)(5)(B)) would neither be subject to tax under chapter 1 of subtitle A of the Internal Revenue Code for the taxable year in which the dividends arise (subject to tax) nor be includible in the earnings and profits of a controlled foreign corporation, as defined in section 957 and without regard to section 953(c) (includible by a controlled foreign corporation).

(c) Use of a partnership, option (or similar interest), or other arrangement. If a partnership, option (or similar interest), or other arrangement, is used with a principal purpose of avoiding the application of this section (for example, to treat a transferor as a controlled foreign corporation), then the partnership, option (or similar interest), or other arrangement will be disregarded for purposes of applying this section.

(d) Examples. The following examples illustrate the rules of this section. For purposes of the examples, assume the following facts in addition to the facts stated in the examples:

- (1) FA is a foreign corporation that is not a controlled foreign corporation;
- (2) FA wholly owns DT, a domestic corporation;
- (3) DT wholly owns FS1, a controlled foreign corporation; and
- (4) No portion of a dividend from FS1 would be treated as from sources within

the United States under section 861.

Example 1--(i) Facts. DT has earnings and profits of \$51x, and FS1 has earnings and profits of \$49x. FA transfers DT stock with a fair market value of \$100x to FS1 in exchange for \$100x of cash.

(ii) Analysis. Under section 304(a)(2), the \$100x of cash is treated as a distribution in redemption of the stock of DT. The redemption of the DT stock is treated as a distribution to which section 301 applies pursuant to section 302(d), which ordinarily would be sourced first from FS1 under section 304(b)(2)(A). Without regard to the application of section 304(b)(5)(B), more than 50 percent of the dividend arising from the acquisition, taking into account only the earnings and profits of FS1 pursuant to

paragraph (b) of this section, would neither be subject to tax nor includible by a controlled foreign corporation. In particular, no portion of a dividend from FS1 would be subject to tax or includible by a controlled foreign corporation. Accordingly, section 304(b)(5)(B) and paragraph (b) of this section apply to the transaction, and no portion of the distribution of \$100x is treated under section 301(c)(1) as a dividend out of the earnings and profits of FS1. Furthermore, the \$100x of cash is treated as a dividend to the extent of the earnings and profits of DT (\$51x).

Example 2--(i) Facts. FA and DT own 40 percent and 60 percent, respectively, of the capital and profits interests of PRS, a foreign partnership. PRS wholly owns FS2, a controlled foreign corporation. The FS2 stock has a fair market value of \$100x. FS1 has earnings and profits of \$150x. PRS transfers all of its FS2 stock to FS1 in exchange for \$100x of cash. DT enters into a gain recognition agreement that complies with the requirements set forth in section 4.01 of Notice 2012-15, 2012-9 I.R.B 424, with respect to the portion (60 percent) of the FS2 stock that DT is deemed to transfer to FS1 in an exchange described in section 367(a)(1). See §1.367(a)-1T(c)(3)(i)(A).

(ii) Analysis. Under section 304(a)(1), PRS and FS1 are treated as if PRS transferred its FS2 stock to FS1 in an exchange described in section 351(a) solely for FS1 stock, and, in turn, FS1 redeemed such FS1 stock in exchange for \$100x of cash. The redemption of the FS1 stock is treated as a distribution to which section 301 applies pursuant to section 302(d). Without regard to the application of section 304(b)(5)(B), more than 50 percent of a dividend arising from the acquisition, taking into account only the earnings and profits of FS1 pursuant to paragraph (b) of this section, would be subject to tax. In particular, 60 percent of a dividend from FS1 would be included in DT's distributive share of PRS's partnership income and therefore would be subject to tax. Accordingly, section 304(b)(5)(B) does not apply, and the entire distribution of \$100x is treated under section 301(c)(1) as a dividend out of the earnings and profits of FS1.

(e) Applicability date. This section applies to acquisitions that are completed on or after September 22, 2014.

(f) Expiration date. This section expires on **April 4, 2019**.

Par. 4. Section 1.367(a)-3 is amended by:

1. Revising the paragraph heading of paragraph (c)(3)(iii)(B).
2. Adding paragraph (c)(3)(iii)(C).
3. Redesignating paragraph (c)(11) as paragraph (c)(11)(i).

4. Adding a paragraph heading for paragraph (c)(11) and revising the paragraph heading of newly redesignated paragraph (c)(11)(i).
5. Revising the first sentence of newly redesignated paragraph (c)(11)(i).
6. Adding paragraph (c)(11)(ii).

The additions and revisions read as follows:

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

\* \* \* \* \*

(c) \* \* \*

(3) \* \* \*

(iii) \* \* \*

(B) Special rules for transferee foreign corporation value. \* \* \*

\* \* \* \* \*

(C) [Reserved]. For further guidance, see §1.367(a)-3T(c)(3)(iii)(C).

\* \* \* \* \*

(11) Applicability date of this paragraph (c)--(i) In general. Except as otherwise provided, this paragraph (c) applies to transfers occurring after January 29, 1997. \* \* \*

(ii) [Reserved]. For further guidance, see §1.367(a)-3T(c)(11)(ii).

\* \* \* \* \*

Par. 5. Section 1.367(a)-3T is added to read as follows:

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

(a) through (c)(3)(iii)(B) [Reserved]. For further guidance, see §1.367(a)-3(a) through (c)(3)(iii)(B).



(C) Special rule for U.S. target company value. For purposes of §1.367(a)-3(c)(3)(iii)(A), the fair market value of the U.S. target company includes the aggregate amount of non-ordinary course distributions (NOCDs) made by the U.S. target company. To calculate the aggregate value of NOCDs, the principles of §1.7874-10T, including the rule regarding predecessors in §1.7874-10T(e) and the rule regarding a deemed distribution of stock in certain cases in §1.7874-10T(g), apply. However, this paragraph (c)(3)(iii)(C) does not apply if the principles of the de minimis exception in §1.7874-10T(d) are satisfied.

(4) through (11)(i) [Reserved]. For further guidance, see §1.367(a)-3(c)(4) through (c)(11)(i).

(ii) Applicability date of certain provisions of this paragraph (c). The first and second sentence of paragraph (c)(3)(iii)(C) of this section apply to transfers completed on or after September 22, 2014. The third sentence of paragraph (c)(3)(iii)(C) of this section applies to transfers completed on or after November 19, 2015. Taxpayers may, however, elect to apply the third sentence of paragraph (c)(3)(iii)(C) of this section to transfers completed on or after September 22, 2014, and before November 19, 2015.

(d) through (j) [Reserved]. For further guidance, see §1.367(a)-3(d) through (j).

(k) Expiration date. Paragraph (c)(3)(iii)(C) of this section expires on **April 4, 2019.**

Par. 6. Section 1.367(b)-4 is amended by:

1. Revising paragraph (a).
2. Revising the introductory text of paragraph (b).

3. In paragraph (b)(1)(i)(A)(2), removing the word “and” at the end of the paragraph.
4. In paragraph (b)(1)(i)(B)(2), removing the period at the end of the paragraph and adding “; and” in its place.
5. Adding paragraph (b)(1)(i)(C).
6. Revising paragraph (d)(1).
7. Adding paragraph (h).

The additions and revisions read as follows:

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

(a) [Reserved]. For further guidance, see §1.367(b)-4T(a).

(b) introductory text [Reserved]. For further guidance, see §1.367(b)-4T(b)

introductory text.

(1) \* \* \*

(i) \* \* \*

(C) [Reserved]. For further guidance, see §1.367(b)-4T(b)(1)(i)(C).

\* \* \* \* \*

(d) \* \* \*

(1) [Reserved]. For further guidance, see §1.367(b)-4T(d)(1).

\* \* \* \* \*

(h) [Reserved]. For further guidance, see §1.367(b)-4T(h).

Par. 7. Section 1.367(b)-4T is revised to read as follows:

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

(a) Scope. This section applies to certain acquisitions by a foreign corporation of the stock or assets of a foreign corporation in an exchange described in section 351 or in a reorganization described in section 368(a)(1). Paragraph (b) of this section provides a rule regarding when an exchanging shareholder is required to include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges. Paragraph (c) of this section provides a rule excluding deemed dividends from foreign personal holding company income. Paragraph (d) of this section provides rules for subsequent sales or exchanges. Paragraphs (e) and (f) of this section provide rules regarding certain exchanges following inversion transactions. Paragraph (g) of this section provides definitions and special rules, including special rules regarding triangular reorganizations and recapitalizations. Paragraph (h) of this section provides the applicability dates, and paragraph (i) of this section provides the date of expiration. See also §1.367(a)-3(b)(2) for transactions subject to the concurrent application of sections 367(a) and (b) and §1.367(b)-2 for additional definitions that apply.

(b) Income inclusion. If a foreign corporation (the transferee foreign corporation) acquires the stock of a foreign corporation in an exchange described in section 351 or the stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), then an exchanging shareholder must, if its exchange is described in paragraph (b)(1)(i), (b)(2)(i), or (b)(3) of this section, include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

(b)(1) through (b)(1)(i)(B) [Reserved]. For further guidance, see §1.367(b)-4(b)(1) through (b)(1)(i)(B).

(C) The exchange is not a specified exchange to which paragraph (e)(1) of this section applies.

(b)(1)(ii) through (d) introductory text [Reserved]. For further guidance, see §1.367(b)-4(b)(1)(ii) through (d) introductory text.

(1) Rule. If an exchanging shareholder (as defined in §1.1248-8(b)(1)(iv)) is not required to include in income as a deemed dividend the section 1248 amount under §1.367(b)-4(b) or paragraph (e)(1) of this section (non-inclusion exchange), then, for purposes of applying section 367(b) or 1248 to subsequent sales or exchanges, and subject to the limitation of §1.367(b)-2(d)(3)(ii) (in the case of a transaction described in §1.367(b)-3), the determination of the earnings and profits attributable to the stock an exchanging shareholder receives in the non-inclusion exchange is determined pursuant to the rules of section 1248 and the regulations under that section.

(2) [Reserved]. For further guidance, see §1.367(b)-4(d)(2).

(e) Income inclusion and gain recognition in certain exchanges following an inversion transaction--(1) General rule. If a foreign corporation (the transferee foreign corporation) acquires stock of a foreign corporation in an exchange described in section 351 or stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), then an exchanging shareholder must, if its exchange is a specified exchange and the exception in paragraph (e)(3) of this section does not apply--

(i) Include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges; and

(ii) After taking into account the increase in basis provided in §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend (if any), recognize all realized gain with respect to the stock that would not otherwise be recognized.

(2) Specified exchanges. An exchange is a specified exchange if--

(i) Immediately before the exchange, the foreign acquired corporation is an expatriated foreign subsidiary and the exchanging shareholder is either an expatriated entity described in §1.367(b)-4(b)(1)(i)(A)(1) or an expatriated foreign subsidiary described in §1.367(b)-4(b)(1)(i)(A)(2);

(ii) The stock received in the exchange is stock of a foreign corporation; and

(iii) The exchange occurs during the applicable period.

(3) De minimis exception. The exception in this paragraph (e)(3) applies if--

(i) Immediately after the exchange, the foreign acquired corporation (in the case of an acquisition of stock of the foreign acquired corporation) or the transferee foreign corporation (in the case of an acquisition of assets of the foreign acquired corporation) is a controlled foreign corporation;

(ii) The post-exchange ownership percentage with respect to the foreign acquired corporation (in the case of an acquisition of stock of the foreign acquired corporation) or the transferee foreign corporation (in the case of an acquisition of assets of the foreign acquired corporation) is at least 90 percent of the pre-exchange ownership percentage with respect to the foreign acquired corporation; and

(iii) The post-exchange ownership percentage with respect to each lower-tier expatriated foreign subsidiary of the foreign acquired corporation is at least 90 percent

of the pre-exchange ownership percentage with respect to the lower-tier expatriated foreign subsidiary.

(4) Certain exceptions from foreign personal holding company not available. An income inclusion of a foreign corporation under paragraph (e)(1) of this section does not qualify for the exceptions from foreign personal holding company income provided by sections 954(c)(3)(A)(i) and 954(c)(6) (to the extent in effect).

(5) Examples. The following examples illustrate the application of this paragraph (e). For purposes of all of the examples, unless otherwise indicated: FP, a foreign corporation, owns all of the stock of USP, a domestic corporation, and all 40 shares of stock of FS, a foreign corporation. USP owns all 50 shares of stock of FT1, a controlled foreign corporation, which, in turn, owns all 50 shares of FT2, a controlled foreign corporation. FP acquired all of the stock of USP in an inversion transaction that was completed on July 1, 2016. Therefore, with respect to that inversion transaction, USP is an expatriated entity; FT1 and FT2 are expatriated foreign subsidiaries; and FP and FS are each a non-CFC foreign related person. All shares of stock have a fair market value of \$1x, and each corporation has a single class of stock outstanding.

Example 1. Specified exchange to which general rule applies--(i) Facts. During the applicable period, and pursuant to a reorganization described in section 368(a)(1)(B), FT1 transfers all 50 shares of FT2 stock to FS in exchange solely for 50 newly issued voting shares of FS. Immediately before the exchange, USP is a section 1248 shareholder with respect to FT1 and FT2. At the time of the exchange, the FT2 stock owned by FT1 has a fair market value of \$50x and an adjusted basis of \$5x, such that the FT2 stock has a built-in gain of \$45x. In addition, the earnings and profits of FT2 attributable to FT1's stock in FT2 for purposes of section 1248 is \$30x, taking into account the rules of §1.367(b)-2(c)(1)(i) and (ii), and therefore the section 1248 amount with respect to the FT2 stock is \$30x (the lesser of the \$45x of built-in gain and the \$30x of earnings and profits attributable to the stock).

(ii) Analysis. FT1's exchange is a specified exchange because the requirements set forth in paragraphs (e)(2)(i) through (iii) of this section are satisfied. The

requirement set forth in paragraph (e)(2)(i) of this section is satisfied because, immediately before the exchange, FT2 (the foreign acquired corporation) is an expatriated foreign subsidiary and FT1 (the exchanging shareholder) is an expatriated foreign subsidiary that is described in §1.367(b)-4(b)(1)(i)(A)(2). The requirement set forth in paragraph (e)(2)(ii) of this section is also satisfied because the stock received in the exchange (FS stock) is stock of a foreign corporation. The requirement set forth in paragraph (e)(2)(iii) of this section is satisfied because the exchange occurs during the applicable period. Accordingly, under paragraph (e)(1)(i) of this section, FT1 must include in income as a deemed dividend \$30x, the section 1248 amount with respect to its FT2 stock. In addition, under paragraph (e)(1)(ii) of this section, FT1 must, after taking into account the increase in basis provided in §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend (which increases FT1's basis in its FT2 stock from \$5x to \$35x), recognize \$15x (\$50x amount realized less \$35x basis), the realized gain with respect to the FT2 stock that would not otherwise be recognized.

Example 2. De minimis shift to non-CFC foreign related persons--(i) Facts. The facts are the same as in the introductory sentences of this paragraph (e)(5) that precede Example 1 of this paragraph (e)(5), except as follows. FT1 does not own any shares of FT2, and all 40 shares of FS are owned by DX, a domestic corporation wholly owned by individual A, and thus FS is not a non-CFC foreign related person. During the applicable period and pursuant to a reorganization described in section 368(a)(1)(D), FT1 transfers all of its assets to FS in exchange for 50 newly issued FS shares, FT1 distributes the 50 FS shares to USP in liquidation under section 361(c)(1), and USP exchanges its 50 shares of FT1 stock for the 50 FS shares under section 354. Further, immediately after the exchange, FS is a controlled foreign corporation.

(ii) Analysis. Although USP's exchange is a specified exchange, paragraph (e)(1) of this section does not apply to the exchange because, as described in paragraphs (ii)(A) through (C) of this Example 2, the requirements of paragraph (e)(3) of this section are satisfied.

(A) Because the assets, rather than the stock, of FT1 (the foreign acquired corporation) are acquired, the requirement set forth in paragraph (e)(3)(i) of this section is satisfied if FS (the transferee foreign corporation) is a controlled foreign corporation immediately after the exchange. As stated in the facts, FS is a controlled foreign corporation immediately after the exchange.

(B) The requirement set forth in paragraph (e)(3)(ii) of this section is satisfied if the post-exchange ownership percentage with respect to FS is at least 90% of the pre-exchange ownership percentage with respect to FT1. Because USP, a domestic corporation that is an expatriated entity, directly owns 50 shares of FT stock immediately before the exchange, none of those shares are treated as indirectly owned by FP (a non-CFC foreign related person) for purposes of calculating the pre-exchange ownership percentage with respect to FT1. See paragraph (g)(1) of this section. Thus, for purposes of calculating the pre-exchange ownership percentage with respect to FT1, FP is treated as directly or indirectly owning 0%, or 0 of 50 shares, of the stock of FT1.

Accordingly, the pre-exchange ownership percentage with respect to FT1 is 100 (calculated as 100% less 0%, the percentage of FT1 stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately before the exchange). Consequently, for the requirement set forth in paragraph (e)(3)(ii) of this section to be satisfied, the post-exchange ownership percentage with respect to FS must be at least 90. Because USP, a domestic corporation that is an expatriated entity, directly owns 50 shares of FS stock immediately after the exchange, none of those shares are treated as indirectly owned by FP (a non-CFC foreign related person) for purposes of calculating the post-exchange ownership percentage with respect to FS. See paragraph (g)(1) of this section. Thus, for purposes of calculating the post-exchange ownership percentage with respect to FS, FP is treated as directly or indirectly owning 0%, or 0 of 90 shares, of the stock of FS. As a result, the post-exchange ownership percentage with respect to FS is 100 (calculated as 100% less 0%, the percentage of FS stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately after the exchange). Therefore, because the post-exchange ownership percentage with respect to FS (100) is at least 90, the requirement set forth in paragraph (e)(3)(ii) of this section is satisfied.

(C) Because there is not a lower-tier expatriated foreign subsidiary of FT1, the requirement set forth in paragraph (e)(3)(iii) of this section does not apply.

(f) Gain recognition upon certain transfers of property described in section 351 following an inversion transaction--(1) General rule. If, during the applicable period, an expatriated foreign subsidiary transfers specified property to a foreign corporation (the transferee foreign corporation) in an exchange described in section 351, then the expatriated foreign subsidiary must recognize all realized gain with respect to the specified property transferred that would not otherwise be recognized, unless the exception in paragraph (f)(2) of this section applies.

(2) De minimis exception. The exception in this paragraph (f)(2) applies if--

(i) Immediately after the transfer, the transferee foreign corporation is a controlled foreign corporation; and

(ii) The post-exchange ownership percentage with respect to the transferee foreign corporation is at least 90 percent of the pre-exchange ownership percentage with respect to the expatriated foreign subsidiary.



(3) Examples. The following examples illustrate the application of this paragraph (f). For purposes of all of the examples, unless otherwise indicated: FP, a foreign corporation, owns all of the stock of USP, a domestic corporation, and all 10 shares of stock of FS, a foreign corporation. USP owns all 50 shares of stock of FT, a controlled foreign corporation. FT owns Asset A, which is specified property with a fair market value of \$50x and an adjusted basis of \$10x. FP acquired all of the stock of USP in an inversion transaction that was completed on or after September 22, 2014. Accordingly, with respect to that inversion transaction, USP is an expatriated entity, FT is an expatriated foreign subsidiary, and FP and FS are each a non-CFC foreign related person. All shares of stock have a fair market value of \$1x, and each corporation has a single class of stock outstanding.

Example 1. Transfer to which general rule applies--(i) Facts. In addition to the stock of USP and FS, FP owns Asset B, which has a fair market value of \$40x. During the applicable period, and pursuant to an exchange described in section 351, FT transfers Asset A to FS in exchange for 50 newly issued shares of FS stock, and FP transfers Asset B to FS in exchange for 40 newly issued shares of FS stock. Immediately after the transfer, FS is not a controlled foreign corporation.

(ii) Analysis. Paragraph (f)(1) of this section applies to the transfer by FT (an expatriated foreign subsidiary) of Asset A, which is specified property, to FS (the transferee foreign corporation). Thus, FT must recognize gain of \$40x under paragraph (f)(1) of this section, which is the realized gain with respect to Asset A that would not otherwise be recognized (\$50x amount realized less \$10x basis). For rules regarding whether the FS stock held by FT is treated as United States property for purposes of section 956, see §1.956-2T(a)(4)(i).

Example 2. De minimis shift to non-CFC foreign related persons--(i) Facts. Individual, a United States person, owns Asset B, which has a fair market value of \$40x. During the applicable period, and pursuant to an exchange described in section 351, FT transfers Asset A to FS in exchange for 50 newly issued shares of FS stock, and Individual transfers Asset B to FS in exchange for 40 newly issued shares of FS stock.

(ii) Analysis. Paragraph (f)(1) of this section does not apply to the transfer by FT (an expatriated foreign subsidiary) of Asset A, which is specified property, to FS (the transferee foreign corporation) because the requirements set forth in paragraph (f)(2) of

this section are satisfied. FS is a controlled foreign corporation immediately after the transfer because 90 out of FS's 100 outstanding shares are owned (within the meaning of section 958(a)) by Individual and USP, who are both United States shareholders (within the meaning of section 951(b)). Accordingly, the requirement set forth in paragraph (f)(2)(i) of this section is satisfied. The requirement set forth in paragraph (f)(2)(ii) of this section is satisfied if the post-exchange ownership percentage with respect to FS is at least 90 percent of the pre-exchange ownership percentage with respect to FT. Because USP, a domestic corporation that is an expatriated entity, directly owns 50 shares of FT stock immediately before the transfer, none of those shares are treated as indirectly owned by FP (a non-CFC foreign related person) for purposes of calculating the pre-exchange ownership percentage with respect to FT. See paragraph (g)(1) of this section. Thus, for purposes of calculating the pre-exchange ownership percentage with respect to FT, FP is treated as directly or indirectly owning 0 percent, or 0 of 50 shares, of the stock of FT. Accordingly, the pre-exchange ownership percentage with respect to FT is 100 (calculated as 100 percent less 0 percent, the percentage of FT stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately before the transfer). Consequently, for the requirement set forth in paragraph (f)(2)(ii) of this section to be satisfied, the post-exchange ownership percentage with respect to FS must be at least 90. Although FP directly owns 10 FS shares, none of the 50 FS shares that FP owns through USP (a domestic corporation that is an expatriated entity) are treated as indirectly owned by FP for purposes of calculating the post-exchange ownership percentage with respect to FS because USP directly owns them. See paragraph (g)(1) of this section. Thus, for purposes of calculating the post-exchange ownership percentage with respect to FS, FP is treated as directly or indirectly owning 10 percent, or 10 of 100 shares, of the stock of FS. As a result, the post-exchange ownership percentage with respect to FS is 90 (calculated as 100 percent less 10 percent, the percentage of FS stock that non-CFC foreign related persons are treated as directly or indirectly owning immediately after the transfer). Therefore, because the post-exchange ownership percentage with respect to FS (90) is at least 90, the requirement set forth in paragraph (f)(2)(ii) of this section is satisfied.

(g) Definitions and special rules. In addition to the definitions and special rules in §§1.367(b)-2 and 1.7874-12T, the following definitions and special rules apply for purposes of this section and §1.367(b)-4.

(1) Indirect ownership. To determine indirect ownership of the stock of a corporation for purposes of calculating a pre-exchange ownership percentage or post-exchange ownership percentage with respect to that corporation, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or

domestic. For this purpose, stock of the corporation that is directly or indirectly (applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic) owned by a domestic corporation that is an expatriated entity is not treated as indirectly owned by a non-CFC foreign related person.

(2) A lower-tier expatriated foreign subsidiary means an expatriated foreign subsidiary whose stock is directly or indirectly owned (under the principles of section 958(a)) by an expatriated foreign subsidiary.

(3) Pre-exchange ownership percentage means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately before an exchange, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(4) Post-exchange ownership percentage means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately after the exchange, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(5) Specified property means any property other than stock of a lower-tier expatriated foreign subsidiary.

(6) Recapitalizations. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as both the foreign acquired corporation and the transferee foreign corporation.

(7) Triangular reorganizations--(i) Definition. A triangular reorganization means a reorganization described in §1.358-6(b)(2)(i) (forward triangular merger), (ii) (triangular

C reorganization), (iii) (reverse triangular merger), (iv) (triangular B reorganization), and (v) (triangular G reorganization).

(ii) Special rules--(A) Triangular reorganizations other than a reverse triangular merger. In the case of a triangular reorganization other than a reverse triangular merger, the surviving corporation is the transferee foreign corporation that acquires the assets or stock of the foreign acquired corporation, and the reference to controlling corporation (foreign or domestic) is to the corporation that controls the surviving corporation.

(B) Reverse triangular merger. In the case of a reverse triangular merger, the surviving corporation is the entity that survives the merger, and the controlling corporation (foreign or domestic) is the corporation that before the merger controls the merged corporation. In the case of a reverse triangular merger, §1.367(b)-4 and this section apply only if stock of the foreign surviving corporation is exchanged for stock of a foreign corporation in control of the merging corporation; in such a case, the foreign surviving corporation is treated as a foreign acquired corporation.

(h) Applicability date of certain paragraphs in this section. Except as otherwise provided in this paragraph (h), this section applies to exchanges completed on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (e)(1)(ii) of this section applies to exchanges completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. The portion of paragraph (e)(2)(i) of this section that requires the exchanging shareholder to be an expatriated entity or an expatriated foreign subsidiary apply to exchanges completed on or after **April 4, 2016**,

but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply the portion of paragraph (e)(2)(i) of this section that requires the exchanging shareholder to be an expatriated entity or an expatriated foreign subsidiary to exchanges completed on or after September 22, 2014, and before **April 4, 2016**. Paragraphs (f) and (g)(5) of this section apply to transfers completed on or after **April 4, 2016**, but only if the inversion transaction was completed or after September 22, 2014. See §1.367(b)-4, as contained in 26 CFR part 1 revised as of April 1, 2016, for exchanges completed before September 22, 2014.

(i) Expiration date. This section expires on or before **April 4, 2019**.

Par. 8. Section 1.956-2 is amended by:

1. Adding paragraphs (a)(4) and (c)(5).
2. Revising paragraph (d)(2).
3. Adding reserved paragraphs (f), (g), and (h).
4. Adding paragraph (i).

The additions and revision read as follows:

§1.956-2 Definition of United States property.

(a) \* \* \*

(4) [Reserved]. For further guidance, see §1.956-2T(a)(4).

\* \* \* \* \*

(c) \* \* \*

(5) [Reserved]. For further guidance, see §1.956-2T(c)(5).

(d) \* \* \*

(2) [Reserved]. For further guidance, see §1.956-2T(d)(2).

\* \* \* \* \*

(f) [Reserved]

(g) [Reserved]

(h) [Reserved]

(i) [Reserved]. For further guidance, see §1.956-2T(i).

Par. 9. Section 1.956-2T is amended by:

1. Adding paragraphs (a)(4) and (c)(5).
2. Revising paragraph (d)(2).
3. Adding reserved paragraph (h).
4. Adding paragraphs (i) and (j).

The additions and revision read as follows:

§1.956-2T Definition of United States property (temporary).

(a)(1) through (3) [Reserved]. For further guidance, see §1.956-2(a)(1) through (3).

(4) Certain foreign stock and obligations held by expatriated foreign subsidiaries following an inversion transaction--(i) General rule. Except as provided in paragraph (a)(4)(ii) of this section, for purposes of section 956 and §1.956-2(a), United States property includes an obligation of a foreign person and stock of a foreign corporation when the following conditions are satisfied--

(A) The obligation or stock is held by a controlled foreign corporation that is an expatriated foreign subsidiary, regardless of whether, when the obligation or stock was

acquired, the acquirer was a controlled foreign corporation or an expatriated foreign subsidiary;

(B) The foreign person or foreign corporation is a non-CFC foreign related person, regardless of whether, when the obligation or stock was acquired, the foreign person or foreign corporation was a non-CFC foreign related person; and

(C) The obligation or stock was acquired--

(1) During the applicable period; or

(2) In a transaction related to the inversion transaction.

(ii) Exceptions. For purposes of section 956 and §1.956-2(a), United States property does not include--

(A) Any obligation of a non-CFC foreign related person arising in connection with the sale or processing of property if the amount of the obligation at no time during the taxable year exceeds the amount that would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the non-CFC foreign related person had the sale or processing transaction been made between unrelated persons; and

(B) Any obligation of a non-CFC foreign related person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities.

(iii) Definitions. The definitions in §1.7874-12T apply for the purposes of the application of paragraphs (a)(4), (c)(5), and (d)(2) of this section.

(iv) Examples. The following examples illustrate the rules of this paragraph (a)(4). For purposes of the examples, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015.

Example 1. (A) Facts. FT acquired an obligation of FS on January 31, 2015.

(B) Analysis. Pursuant to §1.7874-12T, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FS is a non-CFC foreign related person. In addition, FT acquired the FS obligation during the applicable period. Thus, as of January 31, 2015, the obligation of FS is United States property with respect to FT for purposes of section 956(a) and §1.956-2(a).

Example 2. (A) Facts. The facts are the same as in Example 1 of this paragraph (a)(4)(iv), except that on February 15, 2015, FT contributed assets to FS in exchange for 60% of the stock of FS, by vote and value.

(B) Analysis. As a result of the transaction on February 15, 2015, FS becomes a controlled foreign corporation with respect to which an expatriated entity, DT, is a United States shareholder. Accordingly, under §1.7874-12T(a)(9), FS is an expatriated foreign subsidiary, and is therefore not a non-CFC foreign related person. Thus, as of February 15, 2015, the stock and obligation of FS are not United States property with respect to FT for purposes of section 956(a) and §1.956-2(a). FS is not excluded from the definition of expatriated foreign subsidiary pursuant to §1.7874-12T(a)(9)(ii) because FS was not a CFC on the completion date.

Example 3. (A) Facts. Before the acquisition, FA also wholly owns USP, a domestic corporation, which, in turn, wholly owns LFS, a foreign corporation that is a controlled foreign corporation. DT was not a United States shareholder of LFS on or before the completion date. On January 31, 2015, FT contributed assets to LFS in exchange for 60% of the stock of LFS, by vote and value. FT acquired an obligation of LFS on February 15, 2015.

(B) Analysis. LFS is a foreign related person. Because LFS was a controlled foreign corporation and a member of the expanded affiliated group with respect to the inversion transaction on the completion date, and DT was not a United States shareholder with respect to LFS on or before the completion date, LFS is excluded from the definition of expatriated foreign subsidiary pursuant to §1.7874-12T(a)(9)(ii). Thus, pursuant to §1.7874-12T(a)(16), LFS is a non-CFC foreign related person, and the stock and obligation of LFS are United States property with respect to FT for purposes



of section 956(a) and §1.956-2(a). The fact that FT contributed assets to LFS in exchange for 60% of the stock of LFS does not change this result.

Example 4. (A) Facts. The facts are the same as in Example 3 of this paragraph (a)(4)(iv), except that on February 10, 2015, LFS organized a new foreign corporation (LFSS), transferred all of its assets to LFSS, and liquidated, in a transaction treated as a reorganization described in section 368(a)(1)(F), and FT acquired an obligation of LFSS, instead of LFS, on February 15, 2015. On March 1, 2015, LFSS acquired an obligation of FS.

(B) Analysis. LFS is a controlled foreign corporation with respect to which USP, an expatriated entity, is a United States shareholder. USP is an expatriated entity because on the completion date, USP and DT became related to each other within the meaning of section 267(b). Because LFSS was not a member of the expanded affiliated group with respect to the inversion transaction on the completion date, LFSS is not excluded from the definition of expatriated foreign subsidiary pursuant to §1.7874-12T(a)(9)(ii). Accordingly, under §1.7874-12T(a)(9)(i), LFSS is an expatriated foreign subsidiary and is therefore not a non-CFC foreign related person. Thus, the stock and obligation of LFSS are not United States property with respect to FT for purposes of section 956(a) and §1.956-2(a). However, because LFSS is an expatriated foreign subsidiary, pursuant to §1.7874-12T(a)(9), the obligation of FS, a non-CFC foreign related person, is United States property with respect to LFSS for purposes of section 956(a) and §1.956-2(a).

(b)(1) through (b)(1)(x) [Reserved]. For further guidance, see §1.956-2(b)(1) through (b)(1)(x).

\* \* \* \* \*

(b)(2) through (c)(4) [Reserved]. For further guidance, see §1.956-2(b)(2) through (c)(4).

(5) Special guarantee and pledge rule for expatriated foreign subsidiaries--(i)  
General rule. In applying §1.956-2(c)(1) and (2) to a controlled foreign corporation that is an expatriated foreign subsidiary, the phrase “of a United States person or a non-CFC foreign related person” is substituted for the phrase “of a United States person” each place it appears.

(ii) Additional rules. The rule in paragraph (c)(5)(i) of this section--

(A) Applies regardless of whether, when the pledge or guarantee was entered into or treated as entered into, the controlled foreign corporation was a controlled foreign corporation or an expatriated foreign subsidiary, or a foreign person whose obligation is subject to the pledge or guarantee, or deemed pledge or guarantee, was a non-CFC foreign related person; and

(B) Applies to pledges or guarantees entered into, or treated pursuant to §1.956-2(c)(2) as entered into--

(1) During the applicable period; or

(2) In a transaction related to the inversion transaction.

(d)(1) [Reserved]. For further guidance, see §1.956-2(d)(1).

(2) Obligation defined. For purposes of section 956 and §1.956-2, the term “obligation” includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest, except that the term does not include--

(i) Any indebtedness arising out of the involuntary conversion of property which is not United States property within the meaning of §1.956-2(a)(1) or §1.956-2T(a);

(ii) Any obligation of a United States person (as defined in section 957(c)) arising in connection with the provision of services by a controlled foreign corporation to the United States person if the amount of the obligation outstanding at any time during the taxable year of the controlled foreign corporation does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the controlled foreign corporation and the United States person if they were unrelated. The amount of

the obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days;

(iii) Any obligation of a non-CFC foreign related person arising in connection with the provision of services by an expatriated foreign subsidiary to the non-CFC foreign related person if the amount of the obligation outstanding at any time during the taxable year of the expatriated foreign subsidiary does not exceed an amount which would be ordinary and necessary to carry on the trade or business of the expatriated foreign subsidiary and the non-CFC foreign related person if they were unrelated. The amount of the obligations shall be considered to be ordinary and necessary to the extent of such receivables that are paid within 60 days;

(iv) Unless a controlled foreign corporation applies the exception provided in paragraph (d)(2)(v) of this section with respect to the obligation, any obligation of a United States person (as defined in section 957(c)) that is collected within 30 days from the time it is incurred (a 30-day obligation), unless the controlled foreign corporation that holds the 30-day obligation holds for 60 or more calendar days during the taxable year in which it holds the 30-day obligation any obligations which, without regard to the exclusion described in this paragraph (d)(2)(iv), would constitute United States property within the meaning of section 956 and §1.956-2(a); or

(v) Unless a controlled foreign corporation applies the exception provided in paragraph (d)(2)(iv) of this section with respect to the obligation, any obligation of a United States person (as defined in section 957(c)) that is collected within 60 days from the time it is incurred (a 60-day obligation), unless the controlled foreign corporation that holds the 60-day obligation holds for 180 or more calendar days during the taxable year

in which it holds the 60-day obligation any obligations which, without regard to the exclusion described in this paragraph (d)(2)(v), would constitute United States property within the meaning of section 956 and §1.956-2(a).

\* \* \* \* \*

(h) [Reserved]

(i) Effective/applicability date. (1) Except as otherwise provided in this paragraph (i)(1), paragraphs (a)(4) and (c)(5) of this section apply to obligations or stock acquired or to pledges or guarantees entered into, or treated as entered into, on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. The phrase “, regardless of whether, when the obligation or stock was acquired, the acquirer was a controlled foreign corporation or an expatriated foreign subsidiary” in paragraph (a)(4)(i)(A) of this section, the phrase “regardless of whether, when the obligation or stock was acquired, the foreign person or foreign corporation was a non-CFC foreign related person” in paragraph (a)(4)(i)(B) of this section, and paragraphs (a)(4)(i)(C)(2), (c)(5)(ii)(A), and (c)(5)(ii)(B)(2) of this section apply to obligations or stock acquired or pledges or guarantees entered into or treated as entered into on or after **April 4, 2016**, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (a)(4)(ii) of this section applies to obligations acquired on or after **April 4, 2016**. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (a)(4)(ii) of this section to an obligation acquired before **April 4, 2016**. For purposes of paragraph (a)(4)(i) of this section and this paragraph (i)(1), a deemed exchange of an obligation or stock pursuant to section 1001 constitutes an acquisition of the obligation

or stock. For purposes of paragraph (c)(5) of this section and this paragraph (i)(1), a pledgor or guarantor or deemed pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of §1.1001-3(e), of an obligation with respect to which it is a pledgor or guarantor or is treated as a pledgor or guarantor.

(2) Paragraphs (d)(2)(i) and (ii) of this section are effective June 14, 1988, with respect to investments made on or after June 14, 1988.

(3) Paragraph (d)(2)(iii) of this section applies to obligations acquired on or after **April 4, 2016**, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (d)(2)(iii) of this section to an obligation acquired on or after September 22, 2014, and before **April 4, 2016**. For purposes of paragraph (d)(2)(iii) of this section and this paragraph (i)(3), a significant modification, within the meaning of §1.1001-3(e), of an obligation on or after **April 4, 2016**, constitutes an acquisition of an obligation on or after **April 4, 2016**.

(4) Paragraph (d)(2)(iv) of this section applies to obligations held on or after September 16, 1988.

(5) Paragraph (d)(2)(v) of this section applies to the first three taxable years of a foreign corporation ending after October 3, 2008, other than taxable years of a foreign corporation beginning on or after January 1, 2011, as well as the fourth taxable year of a foreign corporation, if any, when the foreign corporation's third taxable year (including any short taxable year) ended after October 3, 2008, and on or before December 31, 2009.

(j) Expiration date. The applicability of paragraphs (a)(4), (c)(5), and (d)(2) of this section expires on or before **April 4, 2019**.

Par. 10. Section 1.7701(l)-4T is added to read as follows:

§1.7701(l)-4T Rules regarding inversion transactions (temporary).

(a) Overview. This section provides rules applicable to United States shareholders of controlled foreign corporations after certain inversion transactions. Paragraph (b) of this section defines specified transactions and provides the scope of the rules in this section. Paragraph (c) of this section provides rules recharacterizing certain specified transactions. Paragraph (d) of this section sets forth rules governing transactions that affect the stock of an expatriated foreign subsidiary following a recharacterized specified transaction. Paragraph (e) of this section sets forth a rule concerning the treatment of amounts included in income as a result of a specified transaction as foreign personal holding company income. Paragraph (f) of this section sets forth definitions that apply for purposes of this section. Paragraph (g) of this section sets forth examples illustrating these rules. Paragraph (h) of this section provides applicability dates, and paragraph (i) of this section provides the date of expiration. See §1.367(b)-4T(e) for rules concerning certain other exchanges after an inversion transaction. See also §1.956-2T(a)(4), (c)(5), and (d)(2) for additional rules applicable to United States property held by controlled foreign corporations after an inversion transaction.

(b) Specified transaction--(1) In general. Except as provided in paragraph (b)(2) of this section, paragraph (c) of this section applies to specified transactions. For purposes of this section, a specified transaction is, with respect to an expatriated foreign

subsidiary, a transaction in which stock of the expatriated foreign subsidiary is issued or transferred to a person that immediately before the issuance or transfer is a specified related person, provided the transaction occurs during the applicable period. However, a specified transaction does not include a transaction in which stock of the expatriated foreign subsidiary is deemed issued pursuant to section 304.

(2) Exceptions. Paragraph (c) of this section does not apply to a specified transaction--

(i) That is a fast-pay arrangement that is recharacterized under §1.7701(l)-3(c)(2);

(ii) In which the specified stock was transferred by a shareholder of the expatriated foreign subsidiary, and the shareholder either--

(A) Pursuant to §1.367(b)-4T(e)(1), both--

(1) Included in gross income as a deemed dividend the section 1248 amount attributable to the specified stock; and

(2) After taking into account the increase in basis provided in §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend (if any), recognized all realized gain with respect to the stock that otherwise would not have been recognized; or

(B) Included in gross income all of the gain recognized on the transfer of the specified stock (including gain included in gross income as a dividend pursuant to section 964(e), section 1248(a), or section 356(a)(2)); or

(iii) In which--

(A) Immediately after the specified transaction and any related transaction, the expatriated foreign subsidiary is a controlled foreign corporation;

(B) The post-transaction ownership percentage with respect to the expatriated foreign subsidiary is at least 90 percent of the pre-transaction ownership percentage with respect to the expatriated foreign subsidiary; and

(C) The post-transaction ownership percentage with respect to any lower-tier expatriated foreign subsidiary is at least 90 percent of the pre-transaction ownership percentage with respect to the lower-tier expatriated foreign subsidiary. See Example 3 and Example 4 of paragraph (g) of this section.

(c) Recharacterization of specified transactions--(1) In general. Except as otherwise provided, a specified transaction that is recharacterized under this paragraph (c) is recharacterized for all purposes of the Internal Revenue Code as of the date on which the specified transaction occurs, unless and until the rules of paragraph (d) of this section apply to alter or terminate the recharacterization. For purposes of paragraphs (c)(2) and (3) and (d) of this section, stock is considered owned by a section 958(a) U.S. shareholder if it is owned within the meaning of section 958(a) by the section 958(a) U.S. shareholder.

(2) Specified transactions through stock issuance. A specified transaction in which the specified stock is issued by an expatriated foreign subsidiary to a specified related person is recharacterized as follows--

(i) The transferred property is treated as having been transferred by the specified related person to the persons that were section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction, in proportion to the stock of the expatriated foreign subsidiary owned by each section 958(a) U.S.



shareholder, in exchange for deemed instruments in the section 958(a) U.S.

shareholders; and

(ii) The transferred property treated as transferred to the section 958(a) U.S. shareholders pursuant to paragraph (c)(2)(i) of this section is treated as having been contributed by the section 958(a) U.S. shareholders (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the expatriated foreign subsidiary in exchange for deemed issued stock in the expatriated foreign subsidiary. See Example 1, Example 2, and Example 6 of paragraph (g) of this section.

(3) Specified transactions through shareholder transfer. A specified transaction in which specified stock is transferred by shareholders of the expatriated foreign subsidiary to a specified related person is recharacterized as follows--

(i) The transferred property is treated as having been transferred by the specified related person to the persons that were section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction, in proportion to the specified stock owned by each section 958(a) U.S. shareholder, in exchange for deemed instruments in the section 958(a) U.S. shareholders; and

(ii) To the extent the section 958(a) U.S. shareholders are not the transferring shareholders, the transferred property treated as transferred to the section 958(a) U.S. shareholders pursuant to paragraph (c)(3)(i) of this section is treated as having been contributed by the section 958(a) U.S. shareholders (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the transferring shareholder in exchange for equity in the transferring shareholder. See Example 5 of paragraph (g) of this section.

(4) Treatment of deemed instruments following a recharacterized specified transaction--(i) Deemed instruments. The deemed instruments described in paragraphs (c)(2) and (3) of this section have the same terms as the specified stock issued or transferred pursuant to the specified transaction (that is, the disregarded specified stock), other than the issuer. When a distribution is made with respect to the disregarded specified stock, matching seriatim distributions with respect to the deemed issued stock are treated as made by the expatriated foreign subsidiary, through intermediate entities, if any, to the section 958(a) U.S. shareholders, which, in turn, then are treated as making corresponding payments with respect to the deemed instruments to the specified related person.

(ii) Paying agent. The expatriated foreign subsidiary is treated as the paying agent of the section 958(a) U.S. shareholder with respect to the deemed instruments treated as issued by the section 958(a) U.S. shareholder to the specified related person.

(d) Transactions affecting ownership of stock of an expatriated foreign subsidiary following a recharacterized specified transaction--(1) Transfers of stock other than specified stock. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, stock of the expatriated foreign subsidiary, other than disregarded specified stock, that is owned by a section 958(a) U.S. shareholder is transferred, the deemed issued stock treated as owned by the section 958(a) U.S. shareholder as a result of the specified transaction continues to be treated as directly owned by the holder, as are the deemed instruments treated as issued to the specified related person as a result of the specified transaction.

(2) Transactions in which the expatriated foreign subsidiary ceases to be a foreign related person. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, there is a transaction that affects the ownership of the stock (including disregarded specified stock) of the expatriated foreign subsidiary, and, immediately after the transaction, the expatriated foreign subsidiary is not a foreign related person (determined without taking into account the recharacterization under paragraph (c)(2) or (3) of this section), then, immediately before the transaction--

(i) Each section 958(a) U.S. shareholder that is treated as owning deemed issued stock in the expatriated foreign subsidiary under paragraph (c)(2) or (3) of this section is treated as transferring the deemed issued stock (after the deemed issued stock is deemed to be transferred to the section 958(a) U.S. shareholder through intermediate entities, if any, in redemption of equity deemed issued by the intermediate entities pursuant to paragraph (c)(2) or (3) of this section) to the specified related person that is treated as holding the deemed instruments issued by the section 958(a) U.S. shareholder under paragraph (c)(2) or (3) of this section, in redemption of the deemed instruments; and

(ii) The deemed issued stock that is treated as transferred pursuant to paragraph (d)(2)(i) of this section is treated as recapitalized into the disregarded specified stock actually held by the specified related person, which immediately thereafter is treated as specified stock owned by the specified related person for all purposes of the Internal Revenue Code. See Example 8, Example 9, and Example 12 of paragraph (g) of this section.

(3) Transfers in which disregarded specified stock ceases to be held by a foreign related person, specified related person, or expatriated entity. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, there is a direct or indirect transfer of the disregarded specified stock in the expatriated foreign subsidiary, and immediately after the transfer, the expatriated foreign subsidiary is a foreign related person, then, to the extent that, as a result of the transfer, the disregarded specified stock is actually held (determined without taking into account the recharacterization under paragraph (c)(2) or (3) of this section) by a person that is not a foreign related person, a specified related person, or an expatriated entity, immediately before the transfer--

(i) Each section 958(a) U.S. shareholder that is treated as owning all or a portion of the deemed issued stock in the expatriated foreign subsidiary is treated as transferring the deemed issued stock that is allocable to the transferred disregarded specified stock that is out-of-group transferred disregarded specified stock (after the deemed issued stock is deemed to be transferred to the section 958(a) U.S. shareholder through intermediate entities, if any, in redemption of equity deemed issued by the intermediate entities pursuant to paragraph (c)(2) or (3) of this section) to the specified related person that is treated as holding the deemed instruments allocable to the out-of-group transferred disregarded specified stock, in redemption of the deemed instruments that are allocable to the out-of-group transferred disregarded specified stock; and

(ii) The deemed issued stock that is treated as transferred pursuant to paragraph (d)(3)(i) of this section is treated as recapitalized into the disregarded specified stock

actually held by the specified related person, which immediately thereafter is treated as specified stock owned by the specified related person for all purposes of the Internal Revenue Code. See Example 7 and Example 11 of paragraph (g) of this section.

(4) Certain direct transfers of disregarded specified stock to which unwind rules do not apply. When a specified related person directly transfers the disregarded specified stock of the expatriated foreign subsidiary and paragraphs (d)(2) and (3) of this section do not apply with respect to the transfer, the specified related person is deemed to transfer the deemed instruments allocable to the transferred disregarded specified stock, whether it is in-group transferred disregarded specified stock or out-of-group transferred disregarded specified stock, to the transferee of the specified stock, in lieu of the disregarded specified stock, in exchange for the consideration provided by the transferee for the disregarded specified stock. See Example 10 of paragraph (g) of this section.

(5) Determination of deemed issued stock and deemed instruments allocable to transferred disregarded specified stock--(i) Out-of-group transfers of disregarded specified stock. For purposes of paragraphs (d)(3) and (4) of this section, the portion of the deemed issued stock treated as owned, and of the deemed instruments treated as issued, by each section 958(a) U.S. shareholder as a result of the specified transaction that is allocable to out-of-group transferred disregarded specified stock is the amount that is proportionate to the ratio of the amount of the out-of-group transferred disregarded specified stock to the amount of disregarded specified stock of the expatriated foreign subsidiary that is actually held by the specified related person

immediately before the transfer referred to in paragraph (d)(3) or (4) of this section as a result of the specified transaction.

(ii) In-group direct transfers of disregarded specified stock. For purposes of paragraph (d)(4) of this section, the portion of the deemed issued stock treated as owned by each section 958(a) U.S. shareholder as a result of the specified transaction that is allocable to in-group transferred disregarded specified stock is the amount that is proportionate to the ratio of the amount of the in-group transferred disregarded specified stock to the amount of disregarded specified stock of the expatriated foreign subsidiary that is actually held by the specified related person immediately before the transfer described in paragraph (d)(4) of this section as a result of the specified transaction.

(e) Certain exception from foreign personal holding company income not available. An amount included in the gross income of a controlled foreign corporation as a dividend with respect to stock transferred in a specified transaction does not qualify for the exception from foreign personal holding company income provided by section 954(c)(6) (to the extent in effect).

(f) Definitions. In addition to the definitions in §1.7874-12T, the following definitions and special rules apply for purposes of this section:

(1) Deemed instruments mean, with respect to a specified transaction, instruments deemed issued by a section 958(a) U.S. shareholder in exchange for transferred property in the specified transaction.

(2) Deemed issued stock means, with respect to a specified transaction, stock of an expatriated foreign subsidiary deemed issued to a section 958(a) U.S. shareholder (or an intermediate entity) in the specified transaction.

(3) Disregarded specified stock means, with respect to a specified transaction, specified stock that is actually held by a specified related person but that is disregarded for all purposes of the Internal Revenue Code pursuant to paragraph (c)(2) or (3) of this section.

(4) Indirect ownership. To determine indirect ownership of the stock of a corporation for purposes of calculating a pre-transaction ownership percentage or post-transaction ownership percentage with respect to that corporation, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or domestic. For this purpose, stock of the corporation that is directly or indirectly (applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic) owned by a domestic corporation that is an expatriated entity is not treated as indirectly owned by a non-CFC foreign related person.

(5) In-group transferred disregarded specified stock means disregarded specified stock that is directly transferred to a foreign related person, a specified related person, or an expatriated entity.

(6) A lower-tier expatriated foreign subsidiary means an expatriated foreign subsidiary, stock of which is directly or indirectly owned by an expatriated foreign subsidiary.

(7) Out-of-group transferred disregarded specified stock means disregarded specified stock that, as a result of a transfer of disregarded specified stock, is actually held by a person that is not a foreign related person, a specified related person, or an expatriated entity.

(8) Pre-transaction ownership percentage means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately before a specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(9) Post-transaction ownership percentage means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately after the specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-CFC foreign related persons.

(10) A section 958(a) U.S. shareholder means, with respect to an expatriated foreign subsidiary, a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock of the expatriated foreign subsidiary and that is an expatriated entity.

(11) Specified stock means the stock of the expatriated foreign subsidiary that is issued or transferred to a specified related person in a specified transaction.

(12) Transferred property means the property transferred by the specified related person in exchange for specified stock in a specified transaction.

(g) Examples. The following examples illustrate the regulations described in this section. Except as otherwise provided, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015. Accordingly, DT is the domestic entity and a section 958(a) U.S. shareholder with



respect to FT, FT is an expatriated foreign subsidiary, and FA and FS are non-CFC foreign related persons and specified related persons.

Example 1. (i) Facts. On February 1, 2015, FA acquires \$6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for \$6x of cash.

(ii) Analysis. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period. Furthermore, the exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) FA's acquisition of the FT specified stock is recharacterized under paragraphs (c)(1) and (2) of this section as follows, with the result that FT continues to be a CFC:

(1) DT is treated as having issued deemed instruments to FA in exchange for \$6x of cash.

(2) DT is treated as having contributed the \$6x of cash to FT in exchange for deemed issued stock of FT.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock issued to FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FA. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FA.

Example 2. (i) Facts. DT owns stock of FT representing 60% of the total voting power and value of the stock of FT, and the remaining stock of FT, representing 40% of the total voting power and value, is owned by USP, a domestic corporation that is not an expatriated entity. On February 1, 2015, FA acquires \$6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for \$6x of cash.

(ii) Analysis. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period. Furthermore, the exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) FA's acquisition of the FT specified stock is recharacterized under paragraphs (c)(1) and (2) of this section as follows, with the result that FT continues to be a CFC:

(1) DT is treated as having issued deemed instruments to FA in exchange for \$6x of cash.

(2) DT is treated as having contributed the \$6x of cash to FT in exchange for deemed issued stock of FT.

(3) DT is treated as owning \$8.40x of the stock of FT, representing 84% of the total voting power and value of the stock of FT. USP owns \$1.60x of the stock of FT, representing 16% of the total voting power and value of the stock of FT.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock issued to FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FA. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FA.

Example 3. (i) Facts. DT owns stock of FT representing 50% of the total voting power and value of the \$8x of stock of FT outstanding, and the remaining stock of FT, representing 50% of the total voting power and value, is owned by USP, a domestic corporation that is not an expatriated entity. On April 30, 2016, FA and USP each simultaneously acquire \$1x of FT stock from FT in a stock issuance, in exchange for \$1x of cash each.

(ii) Analysis. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period.

(B) However, the specified transaction is not recharacterized under paragraphs (c)(1) and (2) of this section because the exception in paragraph (b)(2)(iii) of this section applies. The exception applies because FT remains a controlled foreign corporation immediately after the specified transaction and any related transaction, and the post-transaction ownership percentage with respect to FT is 90% (90%/100%), or at least 90%, of the pre-transaction ownership percentage with respect to FT. The rule in paragraph (b)(2)(iii)(C) of this section does not apply because there is no lower-tier expatriated foreign subsidiary. Although FA (a non-CFC foreign related person) indirectly owns \$4x of FT stock both immediately before and after the specified transaction and any related transaction, all of that stock is directly owned by DT (a domestic corporation that is a section 958(a) U.S. shareholder of FT), and as a result, under paragraph (f)(4) of this section, none of that stock is treated as directly or indirectly owned by FP for purposes of calculating the pre-transaction ownership

percentage and the post-transaction ownership percentage with respect to FT. Accordingly, under paragraph (f)(8) of this section, the pre-transaction ownership percentage with respect to FT (100% less the percentage of stock (by value) in FT that, immediately before the specified transaction with respect to FT and any related transaction, is owned by non-CFC foreign related persons) is 100 (100% - 0%). Under paragraph (f)(9) of this section, the post-transaction ownership percentage with respect to FT (100% less the percentage of stock (by value) in FT that, immediately after the specified transaction with respect to FT and any related transaction, is owned by non-CFC foreign related persons) is 90 (100% - 10% (\$1x/\$10x)).

Example 4. (i) Facts. On February 1, 2015, FA acquires 60% of the FT stock owned by DT in exchange for \$2.40x of cash in a fully taxable transaction. DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FA.

(ii) Analysis. (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock is a specified transaction because stock of an expatriated foreign subsidiary was transferred to a specified related person (FA) during the applicable period.

(B) However, the specified transaction is not recharacterized under paragraphs (c)(1) and (c)(3) of this section because the exception in paragraph (b)(2)(ii) of this section applies. The exception applies because DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT specified stock transferred to FA.

Example 5. (i) Facts. On February 1, 2015, DT and FA organize FPRS, a foreign partnership, with nominal capital. DT transfers all of the stock of FT to FPRS in exchange for 40% of the capital and profits interests in the partnership. Furthermore, FA contributes property to FPRS in exchange for the other 60% of the capital and profits interests.

(ii) Analysis. (A) Under paragraph (b) of this section, DT's transfer of the FT specified stock is a specified transaction, because stock of an expatriated foreign subsidiary was transferred to a specified related person (FPRS) during the applicable period. The exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) DT's transfer of the FT specified stock is recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows, with the result that FT continues to be a CFC:

(1) FPRS is treated as having issued 40% of its capital and profits interests to DT in exchange for deemed instruments treated as having been issued by DT.

(2) DT is treated as continuing to own all of the stock of FT, as well as the FPRS interests.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock transferred to FPRS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FPRS. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FPRS.

Example 6. (i) Facts. DT wholly owns FT2, a foreign corporation that is a controlled foreign corporation. FT and FT2 each own 50% of the capital and profits interests in DPRS, a domestic partnership. DPRS wholly owns FT3, a foreign corporation that is a controlled foreign corporation. FT2 and FT3 are expatriated foreign subsidiaries. On April 30, 2016, FS acquires \$9x of the stock of each of FT and FT2, representing 9% of the total voting power and value of the stock of FT and FT2, from FT and FT2, respectively, in a stock issuance, in exchange for cash of \$9x each. Also on April 30, 2016, in a related transaction, FS acquires \$9x of the stock of FT3, representing 9% of the total voting power and value of the stock of FT3, from FT3 in a stock issuance, in exchange for cash of \$9x.

(ii) Analysis. (A) Under paragraph (b) of this section, the acquisitions by FS of the specified stock of each of FT, FT2, and FT3 from FT, FT2, and FT3 are specified transactions with respect to each of FT, FT2, and FT3, respectively, because stock of an expatriated foreign subsidiary was issued to a specified related person (FS) during the applicable period.

(B) If FS had acquired only stock of FT and FT2, and had not acquired stock of FT3 in a related transaction, the specified transactions resulting from the acquisitions with respect to FT and FT2 would not have been recharacterized under paragraphs (c)(1) and (2) of this section, because the exception from recharacterization in paragraph (b)(2)(iii) of this section would have applied. FT and FT2 remain controlled foreign corporations (within the meaning of section 957) immediately after each specified transaction and any related transaction. Under paragraph (f)(9) of this section, the post-transaction ownership percentage with respect to each of FT, FT2, and FT3 (a lower-tier expatriated foreign subsidiary of FT and FT2) would have been 91%  $((100\% - 9\%)/(100\% - 0\%))$ , or at least 90%, of the pre-transaction ownership percentage determined under paragraph (f)(8) of this section with respect to each of FT, FT2, and FT3 (100%).

(C) However, for the specified transactions with respect to FT, FT2, and FT3, the post-transaction ownership percentage determined under paragraph (f)(9) of this section with respect to FT3 (the lower-tier expatriated foreign subsidiary of FT and FT2), 100% less the percentage of stock (by value) in FT3 that, immediately after each of the specified transactions with respect to each of FT and FT2 and any related transaction, is owned by the non-CFC foreign related persons, is 82.81  $(100\% - (9\% \times 50\% \times 91\%))$ .

(9% $\times$ 50% $\times$ 91%)-9%). Accordingly, the post-transaction ownership percentage with respect to FT3 is 82.81% (82.81/(100%-0%)), which is less than 90%, of the pre-transaction ownership percentage determined under paragraph (f)(8) of this section with respect to FT3. Thus, the exception from recharacterization in paragraph (b)(2)(iii) of this section does not apply with respect to the specified transactions with respect to FT, FT2, or FT3.

(D) The specified transactions with respect to FT and FT2 are recharacterized under paragraphs (c)(1) and (2) of this section as follows:

(1) DT is treated as having issued 2 deemed instruments worth \$9x each to FA in exchange for \$18x (\$9x + \$9x) of cash.

(2) DT is treated as having contributed \$9x of cash to each of FT and FT2 in exchange for deemed issued stock of FT and FT2.

(3) DT is treated as continuing to own all of the stock of FT and FT2.

(E) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT and FT2 specified stock issued to FS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FS. Under paragraph (c)(4)(ii) of this section, FT and FT2 are treated as the paying agents of DT with respect to the deemed instruments issued by DT to FS.

(F) The specified transaction with respect to FT3 is recharacterized under paragraphs (c)(1) and (2) of this section as follows:

(1) DPRS is treated as having issued a deemed instrument worth \$9x to FA in exchange for \$9x of cash.

(2) DPRS is treated as having contributed \$9x of cash to FT3 in exchange for deemed issued stock of FT3.

(3) DPRS is treated as continuing to own all of the stock of FT3.

(G) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT3 specified stock issued to FS will be treated as a distribution to DPRS, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DPRS is treated as having issued to FS. Under paragraph (c)(4)(ii) of this section, FT3 is treated as the paying agent of DPRS with respect to the deemed instrument issued by DPRS to FS.

Example 7. (i) Facts. The facts are the same as in Example 1 of this paragraph (g). On April 30, 2016, FA transfers \$4x of the FT disregarded specified stock that it

acquired on February 1, 2015 to USP, a domestic corporation that is not an expatriated entity, in exchange for \$4x of cash.

(ii) Results. After the transfer, FT remains a foreign related person. Therefore, paragraph (d)(2) of this section does not apply. However, the \$4x of FT disregarded specified stock transferred to USP ceases to be held by a foreign related person, a specified related person, or an expatriated entity (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(3) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer \$4x ( $\$6x \times (\$4x/\$6x)$ ) of the FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of \$4x ( $\$6x \times (\$4x/\$6x)$ ) of the DT deemed instruments that FA is treated as owning, and the \$4x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

Example 8. (i) Facts. The facts are the same as in Example 7 of this paragraph (g), except that on April 30, 2016, FA transfers all \$6x of the FT disregarded specified stock to USP in exchange for \$6x of cash.

(ii) Results. After the transfer, FT ceases to be a foreign related person (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(2) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer the \$6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the \$6x of DT deemed instruments that FA is treated as owning, and the \$6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

Example 9. (i) Facts. The facts are the same as in Example 7 of this paragraph (g), except that on April 30, 2016, FA transfers \$5.5x of the FT disregarded specified stock to USP in exchange for \$5.5x of cash.

(ii) Results. After the transfer, FT ceases to be a foreign related person (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(2) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer the \$6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the \$6x of DT deemed instruments that FA is treated as owning, and the \$6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code and \$5.5x of which is transferred to USP. The remaining \$0.5x of the specified stock continues to be treated as owned by FA for all purposes of the Code.

Example 10. (i) Facts. The facts are the same as in Example 1 of this paragraph (g). On April 30, 2016, FA transfers \$5x of the FT disregarded specified stock that it acquired on February 1, 2015 to DS, a domestic corporation wholly owned by DT, in exchange for \$5x of cash.

(ii) Results. After the transfer, FT remains a foreign related person because DS is wholly owned by DT. Therefore, paragraph (d)(2) of this section does not apply. Furthermore, the \$5x of FT disregarded specified stock is not, as a result of the transfer, held by a person that is not a foreign related person, a specified related person, or an expatriated entity. Therefore, paragraph (d)(3) of this section does not apply. Because FA, a specified related person, directly transferred disregarded specified stock of FT in a transaction to which paragraphs (d)(2) and (3) of this section do not apply, under paragraph (d)(4) of this section, FA is treated as transferring the \$5x of deemed instruments of DT allocable to the \$5x of in-group transferred disregarded specified stock ( $\$6x \times (\$5x/\$6x)$ ) to DS.

Example 11. (i) Facts. On February 1, 2015, FS acquires \$6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for \$6x of cash. The \$6x of FT stock is specified stock, and the transaction is recharacterized under paragraph (c)(2) of this section. See Example 1 of this paragraph (g). On April 30, 2016, FA transfers stock of FS representing 60% of the total voting power and value of the stock of FS to USP, a domestic corporation that is not an expatriated entity. As a result of the transfer, FS ceases to be a foreign related person.

(ii) Results. After the February 1, 2015 transfer, FT remains a foreign related person because the FT stock is acquired by FS, a foreign related person with respect to DT at that time. Therefore, paragraph (d)(2) of this section does not apply. However, after the March 1, 2015 transfer, because FS ceases to be a foreign related person, it ceases to be a specified related person. Furthermore, the \$6x of disregarded specified stock held before the transaction continues to be held by FS after the transaction, and therefore is not held by a foreign related person, a specified related person, or an expatriated entity after the transaction. Accordingly, under paragraph (d)(3) of this section, immediately before the transfer of FS disregarded specified stock, DT is deemed to transfer \$6x ( $\$6x \times (\$6x/\$6x)$ ) of the FT deemed issued stock that it is treated as owning to FS, the specified related person, in redemption of \$6x ( $\$6x \times (\$6x/\$6x)$ ) of the DT deemed instruments that FS is treated as owning, and the \$6x of FT deemed issued stock deemed transferred to FS is deemed recapitalized into disregarded specified stock actually held by FS, which thereafter is treated as owned by FS for all purposes of the Code, including after the transfer of 60% of the FS stock to USP.

Example 12. (i) Facts. The facts are the same as in Example 1 of this paragraph (g). On April 30, 2016, FP, a foreign corporation that is not a foreign related person acquires \$15x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for \$15x of cash.

(ii) Results. After the transaction, FT ceases to be a foreign related person. Therefore, under paragraph (d)(2) of this section, immediately before the issuance of FT stock to FP, DT is deemed to transfer the \$6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the \$6x of DT deemed instruments that FA is treated as owning, and the \$6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which thereafter is treated as owned by FA for all purposes of the Code.

Example 13. (i) Facts. The facts are the same as in Example 1 of this paragraph (g). On April 30, 2016, FS acquires \$4x of the FT stock owned by DT in exchange for \$4x of cash in a fully taxable transaction. DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FS.

(ii) Results. (A) The transfer of FT stock by DT to FS is a specified transaction, but it is not recharacterized under paragraphs (c)(1) and (3) of this section because the exception in paragraph (b)(2)(ii) of this section applies. See Example 4 of this paragraph (g).

(B) After the transfer, FT remains a foreign related person. Therefore, paragraph (d)(2) of this section does not apply. The disregarded specified stock of FT is not, as a result of the transfer, held by a person that is not a foreign related person, a specified related person, or an expatriated entity. Therefore, paragraph (d)(3) of this section does not apply. There has been no direct transfer of specified stock. Therefore, paragraph (d)(4) of this section also does not apply.

(C) Under paragraph (d)(1) of this section, the \$6x of deemed issued stock treated as owned by DT as a result of the specified transaction in which FA acquired FT stock continues to be treated as owned by DT, and the \$6x of deemed instruments treated as issued by DT to FA continue to be treated as owned by FA.

(h) Applicability date. Except as otherwise provided in this paragraph (h), this section applies to specified transactions completed on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014.

Paragraph (b)(2)(ii)(A)(2) of this section applies to specified transactions completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. Paragraphs (d) and (f)(5), (7), and (10) of this section apply to specified transactions completed on or after **April 4, 2016**, but only if the inversion



transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraphs (d) and (f)(5), (7), and (10) of this section to specified transactions completed before **April 4, 2016**. In addition, for inversion transactions completed on or after September 22, 2014, in lieu of applying paragraphs (d) and (f)(5) and (7) of this section to specified transactions completed on or after September 22, 2014, and before **April 4, 2016**, taxpayers may elect to apply the principles of §1.7701(l)-3(c)(3)(iii). Furthermore, for inversion transactions completed on or after September 22, 2014, in lieu of applying paragraph (f)(10) of this section to specified transactions completed on or after September 22, 2014, and before **April 4, 2016**, taxpayers may elect to define a section 958(a) U.S. shareholder as a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock in the expatriated foreign subsidiary, but only if such United States shareholder is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person.

(i) Expiration date. The applicability of this section expires on or before **April 4, 2019**.

Par. 11. Section 1.7874-1 is amended by:

1. Adding paragraph (c)(2)(iii).
2. Redesignating paragraphs (f) and (g) as paragraph (g) and (h).
3. Adding paragraph (f).
4. Further redesignating newly redesignated paragraph (h) as paragraph (h)(1).

5. Adding a paragraph heading for newly redesignated paragraph (h) and revising the paragraph heading of newly redesignated paragraph (h)(1).
6. Removing the language “in this paragraph” in the first sentence of newly redesignated paragraph (h)(1).
7. Adding paragraph (h)(2).

The additions and revision read as follows:

§1.7874-1 Disregard of affiliate-owned stock.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iii) [Reserved]. For further guidance, see §1.7874-1T(c)(2)(iii).

\* \* \* \* \*

(f) [Reserved]. For further guidance, see §1.7874-1T(f).

\* \* \* \* \*

(h) Applicability dates--(1) In general. \* \* \*

(2) [Reserved]. For further guidance, see §1.7874-1T(h)(2).

Par. 12. Section 1.7874-1T is added to read as follows:

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

(a) through (c)(2)(ii) [Reserved]. For further guidance, see §1.7874-1(a) through (c)(2)(ii).

(iii) Special rule. If §1.7874-6T(c)(2) applies for purposes of applying section 7874(c)(2)(A) and §1.7874-1, then, for purposes of §1.7874-1(c)(2) (and so much of §1.7874-1(c)(1) as relates to §1.7874-1(c)(2)), the determination of the EAG after the

acquisition, as well as the determination of stock held by one or more members of the EAG after the acquisition, is made without regard to one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the acquisition, of stock of the acquiring foreign corporation by one or more members of the foreign-parented group described in §1.7874-6T(c)(2)(i).

(c)(3) through (e) [Reserved]. For further guidance, see §1.7874-1(c)(3) through (e).

(f) Treatment of transactions related to the acquisition. Except as provided in paragraph (c)(2)(iii) of this section, all transactions that are related to an acquisition are taken into account in applying this section and §1.7874-1.

(g) through (h)(1) [Reserved]. For further guidance, see §1.7874-1(g) through (h)(1).

(2) Applicability date of certain provisions of this section. Except as provided in this paragraph (h)(2), paragraph (c)(2)(iii) of this section applies to domestic entity acquisitions completed on or after **April 4, 2016**. Except as provided in this paragraph (h)(2), paragraph (f) of this section applies to domestic entity acquisitions completed on or after September 22, 2014. For domestic entity acquisitions completed before **April 4, 2016**, however, taxpayers may elect to consistently apply paragraphs (c)(2)(iii) and (f) of this section, and §1.7874-6T(c)(2), (d)(2), and (f)(2)(ii).

(i) Expiration date. This section expires on **April 4, 2019**.

Par. 13. Section 1.7874-2 is amended by:

1. Revising paragraph (a).
2. Revising the introductory text of paragraph (b).

3. Removing paragraphs (b)(2) through (4).
4. Redesignating paragraphs (b)(5) through (9) as paragraphs (b)(2) through (6), respectively.
5. Adding paragraphs (b)(7) through (13).
6. Revising paragraph (c)(2).
7. Adding paragraph (c)(4).
8. Revising the introductory text of paragraph (f)(1).
9. Adding paragraph (f)(1)(iv).
10. Adding Example 21 to paragraph (k)(2).
11. Redesignating paragraph (l) as paragraph (l)(1).
12. Adding a paragraph heading for paragraph (l) and revising the heading of newly redesignated paragraph (l)(1).
13. Adding paragraph (l)(2).
14. For each paragraph listed in the following table, removing the language in the “Remove” column and adding in its place the language in the “Add” column:

<u>Paragraph</u>	<u>Remove</u>	<u>Add</u>
Newly redesignated (b)(6)	acquisition described in section 7874(a)(2)(B)(i)	domestic entity acquisition
(d)	an acquisition described in section 7874(a)(2)(B)(i)	a domestic entity acquisition
(e)	acquisitions described in section 7874(a)(2)(B)(i)	domestic entity acquisitions
(e)	former shareholders	former domestic entity shareholders
(e)	former partners	former domestic entity partners
(g)(2)(i)	acquisition described in section 7874(a)(2)(B)(i)	domestic entity acquisition
(g)(2)(ii)	acquisition	domestic entity acquisition
(g)(6)	acquisition described in	domestic entity acquisition

	section 7874(a)(2)(B)(i)	
(h)(3)(i) and (ii) and (h)(4)(ii)	acquisition described in section 7874(a)(2)(B)(i)	domestic entity acquisition
(i)(2)(i) and (ii)	an acquisition described in section 7874(a)(2)(B)(i)	a domestic entity acquisition
(j)(1) and (3)	acquisition described in section 7874(a)(2)(B)(i)	domestic entity acquisition
(k)(2), <u>Examples 7, 11, 13, 19, 20</u>	former shareholders	former domestic entity shareholders
(k)(2), <u>Examples 12, 14, 15, and 16</u>	acquisition	domestic entity acquisition
(k)(2), <u>Example 19</u>	acquisition described in section 7874(a)(2)(B)(i)	domestic entity acquisition
(l)	acquisitions	domestic entity acquisitions

The revisions and additions read as follows:

§1.7874-2 Surrogate foreign corporation.

(a) [Reserved]. For further guidance, see §1.7874-2T(a).

(b) Definitions and special rules. In addition to the definitions in §1.7874-12T, the following definitions and special rules apply for purposes of this section.

\* \* \* \* \*

(b)(7) through (13) [Reserved]. For further guidance, see §1.7874-2T(b)(7) through (13).

(c) \* \* \*

(2) [Reserved]. For further guidance, see §1.7874-2T(c)(2).

\* \* \* \* \*

(4) [Reserved]. For further guidance, see §1.7874-2T(c)(4).

\* \* \* \* \*

(f) \* \* \*

(1) introductory text [Reserved]. For further guidance, see §1.7874-2T(f)(1) introductory text.

\* \* \* \* \*

(iv) [Reserved]. For further guidance, see §1.7874-2T(f)(1)(iv).

\* \* \* \* \*

(k) \* \* \*

(2) \* \* \*

Example 21 [Reserved]. For further guidance, see §1.7874-2T(k)(2), Example 21.

(l) Applicability date--(1) In general. \* \* \*

(2) [Reserved]. For further guidance, see §1.7874-2T(l)(2).

Par. 14. Section 1.7874-2T is added to read as follows:

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

(a) Scope. This section provides rules for determining whether a foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B). Paragraph (b) of this section provides definitions and special rules. Paragraph (c) of this section provides rules to determine whether a foreign corporation has acquired properties held by a domestic corporation (or a partnership). Paragraph (d) of this section provides rules that apply when two or more foreign corporations complete, in the aggregate, a domestic entity acquisition. Paragraph (e) of this section provides rules that apply when, pursuant to a plan, a single foreign corporation completes more than one domestic entity acquisition. Paragraph (f) of this section provides rules to identify the stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership). Paragraph (g) of this section provides rules that treat certain publicly traded foreign partnerships as foreign

corporations for purposes of section 7874. Paragraph (h) of this section provides rules concerning the treatment of certain options (or similar interests) for purposes of section 7874. Paragraph (i) of this section provides rules that treat certain interests (including debt, stock, or a partnership interest) as stock of a foreign corporation for purposes of section 7874. Paragraph (j) of this section provides rules concerning the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b).

Paragraph (k) of this section provides examples that illustrate the rules of this section.

Paragraph (l) of this section provides the applicability dates of this section, and paragraph (m) provides the date of expiration. For additional definitions that apply for purposes of this section, see §1.7874-12T.

(b) through (b)(6) [Reserved]. For further guidance, see §1.7874-2(b) through (b)(6).

(7) A former initial acquiring corporation shareholder of an initial acquiring corporation means any person that held stock in the initial acquiring corporation before the subsequent acquisition, including any person that holds stock in the initial acquiring corporation both before and after the subsequent acquisition.

(8) An initial acquisition means, with respect to a subsequent acquisition, a domestic entity acquisition occurring, pursuant to a plan that includes the subsequent acquisition (or a series of related transactions), before the subsequent acquisition.

(9) An initial acquiring corporation means, with respect to an initial acquisition, the foreign acquiring corporation.

(10) A subsequent acquisition means, with respect to an initial acquisition, a transaction occurring, pursuant to a plan that includes the initial acquisition (or a series

of related transactions), after the initial acquisition in which a foreign corporation directly or indirectly acquires (within the meaning of paragraph (c)(4)(ii) of this section) substantially all of the properties held directly or indirectly by the initial acquiring corporation.

(11) A subsequent acquiring corporation means, with respect to a subsequent acquisition, the foreign corporation that directly or indirectly acquires substantially all of the properties held directly or indirectly by the initial acquiring corporation.

(12) Special rule regarding initial acquisitions. With respect to an initial acquisition, the determination of the ownership percentage described in section 7874(a)(2)(B)(ii) is made without regard to the subsequent acquisition and all related transactions occurring after the subsequent acquisition.

(13) Special rule regarding subsequent acquisitions. With respect to a subsequent acquisition (or a similar acquisition under the principles of paragraph (c)(4)(i) of this section) that is an inversion transaction, the applicable period begins on the first date that properties are acquired as part of the initial acquisition.

(c) through (c)(1) [Reserved]. For further guidance, see §1.7874-2(c) through (c)(1).

(2) Acquisition of stock of a foreign corporation. Except as provided in paragraph (c)(4) of this section, an acquisition of stock of a foreign corporation that owns directly or indirectly stock of a domestic corporation (or an interest in a partnership) shall not constitute an indirect acquisition of any properties held by the domestic corporation (or the partnership). See Example 4 of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(2).



(3) [Reserved]. For further guidance, see §1.7874-2(c)(3).

(4) Multiple-step acquisitions--(i) Rule. A subsequent acquisition is treated as a domestic entity acquisition, and the subsequent acquiring corporation is treated as a foreign acquiring corporation. See Example 21 of paragraph (k) of this section for an illustration of this rule. See also paragraph (f)(1)(iv) of this section (treating certain stock of the subsequent acquiring corporation as stock of a foreign corporation that is held by reason of holding stock of, or a partnership interest in, the domestic entity).

(ii) Acquisition of property pursuant to a subsequent acquisition. In determining whether a foreign corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an initial acquiring corporation, the principles of section 7874(a)(2)(B)(i) apply, including §1.7874-2(c) other than §1.7874-2(c)(2). For this purpose, the principles of §1.7874-2(c)(1), including §1.7874-2(b)(5), apply by substituting the term “foreign” for “domestic” wherever it appears.

(iii) Additional related transactions. If, pursuant to the same plan (or a series of related transactions), a foreign corporation directly or indirectly acquires (under the principles of paragraph (c)(4)(ii) of this section) substantially all of the properties directly or indirectly held by a subsequent acquiring corporation in a transaction occurring after the subsequent acquisition, then the principles of paragraph (c)(4)(i) of this section apply to such transaction (and any subsequent transaction or transactions occurring, pursuant to the plan (or the series of related transactions)).

(d) through (f) introductory text [Reserved]. For further guidance, see §1.7874-2(d) through (f) introductory text.

(1) Certain transactions. For purposes of section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) includes, but is not limited to, the stock described in paragraphs (f)(1)(i) through (iv) of this section.

(f)(1)(i) through (f)(1)(iii) [Reserved]. For further guidance, see §1.7874-2(f)(1)(i) through (iii).

(iv) Stock of a subsequent acquiring corporation received by a former initial acquiring corporation shareholder pursuant to a subsequent acquisition in exchange for, or with respect to, stock of an initial acquiring corporation that is held by reason of holding stock of, or a partnership interest in, a domestic entity.

(g) through (k)(2), Example 20 [Reserved]. For further guidance, see §1.7874-2(g) through (k)(2), Example 20.

Example 21. Application of multiple-step acquisition rule--(i) Facts. Individual A owns all 70 shares of stock of DC1, a domestic corporation. Individual B owns all 30 shares of stock of F1, a foreign corporation that is subject to tax as a resident of Country X. Pursuant to a reorganization described in section 368(a)(1)(D), DC1 transfers all of its properties to F1 solely in exchange for 70 newly issued voting shares of F1 stock (DC1 acquisition) and distributes the F1 stock to Individual A in liquidation pursuant to section 361(c)(1). Pursuant to a plan that includes the DC1 acquisition, F2, a newly formed foreign corporation that is also subject to tax as a resident of Country X, acquires 100 percent of the stock of F1 solely in exchange for 100 newly issued shares of F2 stock (F1 acquisition). After the F1 acquisition, Individual A owns 70 shares of F2 stock, Individual B owns 30 shares of F2 stock, F2 owns all 100 shares of F1 stock, and F1 owns all the properties held by DC1 immediately before the DC1 acquisition. In addition, the form of the transaction is respected for U.S. federal income tax purposes.

(ii) Analysis--(A) The DC1 acquisition is a domestic entity acquisition, and F1 is a foreign acquiring corporation, because F1 directly acquires 100 percent of the properties of DC1. In addition, the 70 shares of F1 stock received by A pursuant to the DC1 acquisition in exchange for Individual A's DC1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the DC1 acquisition.

(B) The DC1 acquisition is also an initial acquisition because it is a domestic entity acquisition that, pursuant to a plan that includes the F1 acquisition, occurs before the F1 acquisition (which, as described in paragraph (ii)(C) of this Example 21, is a subsequent acquisition). Thus, F1 is the initial acquiring corporation.

(C) The F1 acquisition is a subsequent acquisition because it occurs, pursuant to a plan that includes the DC1 acquisition, after the DC1 acquisition and, pursuant to the F1 acquisition, F2 acquires 100 percent of the stock of F1 and therefore is treated under paragraph (c)(4)(ii) of this section (which applies the principles of section 7874(a)(2)(B)(i) with certain modifications) as indirectly acquiring substantially all of the properties held directly or indirectly by F1. Thus, F2 is the subsequent acquiring corporation.

(D) Under paragraph (c)(4)(i) of this section, the F1 acquisition is treated as a domestic entity acquisition, and F2 is treated as a foreign acquiring corporation. In addition, under paragraph (f)(1)(iv) of this section, the 70 shares of F2 stock received by Individual A (a former initial acquiring corporation shareholder) pursuant to the F1 acquisition in exchange for Individual A's F1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the F1 acquisition.

(l) through (l)(1) [Reserved]. For further guidance, see §1.7874-2(l) through (l)(1).

(2) Applicability date of certain provisions of this section. Paragraphs (a), (b)(7) through (13), (c)(2) and (4), and (f)(1)(iv) of this section, as well as the introductory text of paragraph (f)(1) and Example 21 of paragraph (k)(2), apply to domestic entity acquisitions completed on or after **April 4, 2016**.

(m) Expiration date. This section expires on **April 4, 2019**.

Par. 15. Section 1.7874-3 is amended by:

1. Revising the second sentence of paragraph (a).
2. Revising the introductory text of paragraph (b).
3. Adding paragraph (b)(4).
4. Revising paragraph (d)(10).

5. Redesignating paragraph (f) as paragraph (f)(1).
6. Adding a paragraph heading for paragraph (f) and revising newly redesignated paragraph (f)(1).
7. Adding paragraph (f)(2).

The revisions and additions read as follows:

§1.7874-3 Substantial business activities.

(a) \* \* \* Paragraph (b) of this section describes the general rule for determining whether the expanded affiliated group has substantial business activities in the relevant foreign country when compared to its total business activities.\* \* \*

(b) General rule. The expanded affiliated group will be considered to have substantial business activities in the relevant foreign country after an acquisition described in section 7874(a)(2)(B)(i) when compared to the total business activities of the expanded affiliated group only if, subject to paragraph (c) of this section, each of the requirements of this paragraph (b) are satisfied.

\* \* \* \* \*

(4) [Reserved]. For further guidance, see §1.7874-3T(b)(4).

\* \* \* \* \*

(d) \* \* \*

\* \* \* \* \*

(10) [Reserved]. For further guidance, see §1.7874-3T(d)(10).

\* \* \* \* \*

(f) Applicability dates--(1) General rule. Except as otherwise provided in paragraph (f)(2) of this section, this section applies to acquisitions that are completed on

or after June 3, 2015. For acquisitions completed before June 3, 2015, see § 1.7874-3T as contained in 26 CFR part 1 revised as of April 1, 2016.

(2) [Reserved]. For further guidance, see §1.7874-3T(f)(2).

Par. 16. Section 1.7874-3T is added to read as follows:

§1.7874-3T Substantial business activities (temporary).

(a) through (b)(3) [Reserved]. For further guidance, see §1.7874-3(a) through 1.7874-3(b)(3).

(4) Tax residence of foreign acquiring corporation. The foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.

(c) through (d)(9) [Reserved]. For further guidance, see §1.7874-3(c) through (d)(9).

(10) The term relevant financial statements means financial statements prepared consistently for all members of the expanded affiliated group in accordance with either U.S. Generally Accepted Accounting Principles (U.S. GAAP) or the International Financial Reporting Standards (IFRS) used for the expanded affiliated group's consolidated financial statements, but, if, after the acquisition described in section 7874(a)(2)(B)(i), financial statements will not be prepared consistently for all members of the expanded affiliated group in accordance with either U.S. GAAP or IFRS, then, for each member, financial statements prepared in accordance with either U.S. GAAP or IFRS. The relevant financial statements must take into account all items of income generated by all members of the expanded affiliated group for the entire testing period.

(d)(11) through (f)(1) [Reserved]. For further guidance, see §1.7874-3(d)(11) through (f)(1).

(2) Paragraphs (b)(4) and (d)(10) of this section. Paragraph (b)(4) of this section applies to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (d)(10) of this section applies to domestic entity acquisitions completed on or after **April 4, 2016**. For domestic entity acquisitions completed on or after June 3, 2015, and before **April 4, 2016**, however, taxpayers may elect to apply paragraph (d)(10) of this section.

(g) Expiration date. The applicability of paragraphs (b)(4) and (d)(10) of this section expires on **April 4, 2019**.

Par. 17. Section 1.7874-4T is amended by:

1. Revising paragraph (d)(1)(i).
2. Revising paragraphs (i)(6) and (i)(7)(iv).
3. In paragraph (j)(7), removing the word “and” at the end of the paragraph.
4. In paragraph (j)(8), removing the period at the end of the paragraph and adding a semicolon in its place.
5. Adding paragraphs (j)(9), (10), and (11) before Example 1 of paragraph (j).
6. In paragraph (ii) of Example 1 of paragraph (j), adding a sentence after the fourth sentence.
7. In paragraph (ii) of Example 2 of paragraph (j), adding a sentence after the fourth sentence.
8. In paragraph (j), redesignating Example 3 through Example 8 as Example 4 through Example 9, respectively.
9. Adding Example 3 to paragraph (j).

10. In paragraph (ii) of newly redesignated Example 5 of paragraph (j), revising the fourth sentence.

11. For each paragraph listed in following the table, removing the language in the “Remove” column and adding in its place the language in the “Add” column:

<u>Paragraph</u>	<u>Remove</u>	<u>Add</u>
(c)(1)(i), last sentence	<u>Example 5</u>	<u>Example 6</u>
(c)(1)(i), last sentence	<u>Example 7</u>	<u>Example 8</u>
(c)(1)(i), last sentence	<u>Example 8</u>	<u>Example 9</u>
(c)(1)(ii)(B), second sentence	<u>Example 5</u>	<u>Example 6</u>
(c)(2), last sentence	<u>Example 3</u>	<u>Example 4</u>
(c)(2), last sentence	<u>Example 6</u>	<u>Example 7</u>
(d)(1)(ii), last sentence	<u>Example 4</u>	<u>Example 5</u>
(h), last sentence	<u>Example 7</u>	<u>Example 8</u>
(h), last sentence	<u>Example 8</u>	<u>Example 9</u>
(i)(7)(iii)(C), last sentence	<u>Example 5</u>	<u>Example 6</u>
(j), newly redesignated <u>Example 4</u> (iii), first sentence	<u>Example 3</u>	<u>Example 4</u>
(j), newly redesignated <u>Example 6</u> (iii), first sentence	<u>Example 5</u>	<u>Example 6</u>
(j), newly redesignated <u>Example 9</u> (iii), first sentence	<u>Example 8</u>	<u>Example 9</u>

12. Revising paragraph (k)(1).

The revisions and additions read as follows:

§1.7874-4T Disregard of certain stock related to the acquisition (temporary).

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \*

(i) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§1.7874-7T(b) and 1.7874-10T(b), is less than five (by vote and value); and

\* \* \* \* \*

(i) \* \* \*

(6) Marketable securities has the meaning set forth in section 453(f)(2), except that the term “marketable securities” does not include stock of a corporation or an interest in a partnership that becomes a member of the expanded affiliated group that includes the foreign acquiring corporation in a transaction (or series of transactions) related to the acquisition. See Example 4 of paragraph (j) of this section for an illustration of this paragraph (i)(6).

(7) \* \* \*

(iv) Any other property acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of property described in paragraph (i)(7)(i), (ii), or (iii) of this section. See Example 2 and Example 3 of paragraph (j) of this section for illustrations of this paragraph (i)(7)(iv).

\* \* \* \* \*

(j) \* \* \*

(9) FA, FMS, FS, and FT are tax residents in the same foreign country;

(10) For purposes of determining the ownership fraction, no shares of FA stock are excluded from the denominator pursuant to §1.7874-7T(b); and

(11) For purposes of determining the ownership fraction, no shares of FA stock are received by former shareholders of DT pursuant to §1.7874-10T(b).



Example 1. \* \* \*

(ii) \* \* \* See also section 7874(c)(4). \* \* \*

Example 2. \* \* \*

(ii) \* \* \* Furthermore, even in the absence of paragraph (i)(7)(iv) of this section, the transfer of marketable securities to FT would be disregarded pursuant to section 7874(c)(4). \* \* \*

Example 3. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874. (i) Facts. DT is a publicly traded corporation. PRS is a foreign partnership that is unrelated to DT. PRS transfers certain business assets (PRS properties) to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. The shareholders of DT transfer all of their DT stock to FA in exchange solely for the remaining 75 shares of FA stock. None of the PRS properties is property described in paragraph (i)(7)(i) through (iii) of this section, but FA acquires the PRS properties with a principal purpose of avoiding the purposes of section 7874.

(ii) Analysis. Under paragraph (i)(7)(iv) of this section, the PRS properties transferred to FA constitute nonqualified property, because FA acquires the PRS properties in a transaction related to the acquisition of the DT stock with a principal purpose of avoiding the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the PRS properties constitute disqualified stock described in paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not apply to reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the PRS properties increases the fair market value of FA's assets by the fair market value of the PRS properties. Accordingly, pursuant to paragraph (b) of this section, the 25 shares of FA stock transferred to PRS in exchange for the PRS properties are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (i)(7)(iv) of this section, the transfer of the PRS properties to FA would be disregarded pursuant to section 7874(c)(4). Therefore, the only FA stock included in the ownership fraction is the FA stock transferred to DT's former shareholders in exchange for their DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

\* \* \* \* \*

Example 5. \* \* \*

(ii) \* \* \* However, without regard to the application of paragraph (b) of this section and §§1.7874-7T(b) and 1.7874-10T(b), the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA

stock held by Individual A by reason of owning the DT stock, determined under §1.7874-2(f)(2), over 100 shares of FA stock outstanding after the acquisition). \* \* \*

\* \* \* \* \*

(k) \* \* \*

(1) Except to the extent provided in this paragraph (k)(1) and paragraph (k)(2) of this section, this section applies to domestic entity acquisitions completed on or after September 17, 2009. Paragraphs (i)(6) and (i)(7)(iv) of this section apply to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (d)(1)(i) of this section applies to domestic entity acquisitions completed on or after **April 4, 2016**. For domestic entity acquisitions completed on or after September 22, 2014, and before **April 4, 2016**, however, taxpayers may elect to apply paragraph (d)(1)(i) of this section. For domestic entity acquisitions completed before November 19, 2015, see paragraphs (i)(6) and (i)(7)(iv) of this section as contained in 26 CFR part 1 revised as of April 1, 2016.

\* \* \* \* \*

Par. 18. Section 1.7874-6T is added to read as follows:

§1.7874-6T Stock transferred by members of the EAG (temporary).

(a) Scope. This section provides rules regarding whether transferred stock is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1. Paragraph (b) of this section sets forth the general rule under which transferred stock is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1. Paragraph (c) of this section provides exceptions to the general rule. Paragraph (d) of this section provides rules regarding the treatment of partnerships, and paragraph (e) of this section provides rules regarding transactions

related to the acquisition. Paragraph (f) of this section provides definitions. Paragraph (g) of this section provides examples illustrating the application of the rules of this section. Paragraph (h) of this section provides dates of applicability, and paragraph (i) of this section provides the date of expiration.

(b) General rule. Except as provided in paragraph (c) of this section, transferred stock is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1. Transferred stock that is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 is included in the numerator and the denominator of the ownership fraction. See §1.7874-5T(a).

(c) Exceptions. Transferred stock is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 if paragraph (c)(1) or (2) of this section applies. Transferred stock that is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 is excluded from the numerator of the ownership fraction and, depending upon the application of §1.7874-1(c), may be excluded from the denominator of the ownership fraction. See §1.7874-1(b) and (c).

(1) Transfers involving a U.S.-parented group. This paragraph (c)(1) applies if the following conditions are satisfied:

(i) Before the domestic entity acquisition, the transferring corporation is a member of a U.S.-parented group.

(ii) After the domestic entity acquisition, each of the transferring corporation (or its successor), any person that holds transferred stock, and the foreign acquiring corporation are members of a U.S.-parented group the common parent of which--

(A) Before the domestic entity acquisition, was a member of the U.S.-parented group described in paragraph (c)(1)(i) of this section; or

(B) Is a corporation that was formed in a transaction related to the domestic entity acquisition, provided that, immediately after the corporation was formed (and without regard to any related transactions), the corporation was a member of the U.S.-parented group described in paragraph (c)(1)(i) of this section.

(2) Transfers involving a foreign-parented group. This paragraph (c)(2) applies if the following conditions are satisfied:

(i) Before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group.

(ii) After the domestic entity acquisition, the transferring corporation--

(A) Is a member of the EAG; or

(B) Would be a member of the EAG absent one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the domestic entity acquisition, of stock of the foreign acquiring corporation by one or more members of the foreign-parented group described in paragraph (c)(2)(i) of this section.

(d) Treatment of partnerships--(1) Stock held by a partnership. For purposes of this section, each partner in a partnership, as determined without regard to the application of paragraph (d)(2) of this section, is treated as holding its proportionate share of the stock held by the partnership, as determined under the rules and principles of sections 701 through 777.

(2) Partnership treated as corporation. For purposes of this section, if one or more members of an affiliated group, as determined after the application of paragraph

(d)(1) of this section, own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership will be treated as a corporation that is a member of the affiliated group.

(e) Treatment of transactions related to the acquisition. Except as provided in paragraphs (c)(1)(ii)(B) and (c)(2)(ii)(B) of this section, all transactions that are related to a domestic entity acquisition are taken into account in applying this section.

(f) Definitions. In addition to the definitions provided in §1.7874-12T, the following definitions apply for purposes of this section.

(1) A foreign-parented group means an affiliated group that has a foreign corporation as the common parent corporation. A member of the foreign-parented group is an entity included in the foreign-parented group.

(2) Transferred stock--(i) In general. Transferred stock means stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that is received by a transferring corporation and, in a transaction (or series of transactions) related to the domestic entity acquisition, is subsequently transferred.

(ii) Special rule. This paragraph (f)(2)(ii) applies in certain cases in which a transferring corporation receives stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that has the same terms as other stock of the foreign acquiring corporation that is received by the transferring corporation in a transaction (or series of transactions) related to the domestic entity acquisition or that is owned by the transferring corporation prior to the domestic entity acquisition (the stock described in this sentence, collectively, fungible stock). Pursuant to this paragraph (f)(2)(ii), if, in a transaction (or series of transactions) related to the domestic entity acquisition, the

transferring corporation subsequently transfers less than all of the fungible stock, a pro rata portion of the stock subsequently transferred is treated as consisting of stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii). The pro rata portion is based, at the time of the subsequent transfer, on the relative fair market value of the fungible stock that is stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) to the fair market value of all the fungible stock.

(3) A transferring corporation means a corporation that is a former shareholder or former partner.

(4) A U.S.-parented group means an affiliated group that has a domestic corporation as the common parent corporation. A member of the U.S.-parented group is an entity included in the U.S.-parented group, including the common parent corporation.

(g) Examples. The following examples illustrate the application of this section.

Example 1. U.S.-parented group exception not available--(i) Facts. USP, a domestic corporation wholly owned by Individual A, owns all the stock of DT, a domestic corporation, as well as other property. The DT stock does not represent substantially all of the property of USP for purposes of section 7874. Pursuant to a reorganization described in section 368(a)(1)(D), USP transfers all the DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to Individual A pursuant to section 361(c)(1).

(ii) Analysis. The 100 FA shares received by USP are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874-5T(a), the shares retain their status as such even though USP subsequently distributes the shares to Individual A pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874-1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section does not apply. Although before the DT acquisition, USP (the transferring

corporation) is a member of a U.S.-parented group of which USP is the common parent, after the DT acquisition, and taking into account all transactions related to the acquisition, each of USP, Individual A (the person that holds the transferred stock), and FA (the foreign acquiring corporation) are not members of a U.S.-parented group described in paragraph (c)(1)(ii)(A) or (B) of this section. Accordingly, because the 100 FA shares are not treated as held by members of the EAG, those shares are included in the numerator and the denominator of the ownership fraction. Therefore, the ownership fraction is 100/100.

Example 2. U.S.-parented group exception available--(i) Facts. USP, a domestic corporation wholly owned by Individual A, owns all the stock of USS, a domestic corporation, and USS owns all the stock of FT, a foreign corporation. FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all of its DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to USS in liquidation pursuant to section 361(c)(1). In a transaction after and related to the DT acquisition, USP sells 60 percent of the stock of USS (by vote and value) to Individual B.

(ii) Analysis. The 100 FA shares received by FT are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874-5T(a), the shares retain their status as such even though FT subsequently distributes the shares to USS pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874-1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section applies. The requirement set forth in paragraph (c)(1)(i) of this section is satisfied because before the DT acquisition, FT (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent (the USP group). The requirement set forth in paragraph (c)(1)(ii) of this section is satisfied because after the DT acquisition, and taking into account all transactions related to the acquisition, each of FA (which is both the successor to FT, the transferring corporation, and the foreign acquiring corporation) and USS (the person that holds the transferred stock) are members of a U.S.-parented group of which USS (a member of the USP group before the DT acquisition) is the common parent. Moreover, the DT acquisition qualifies as an internal group restructuring under §1.7874-1(c)(2). The requirement set forth in §1.7874-1(c)(2)(i) is satisfied because before the DT acquisition, 80 percent or more of the stock (by vote and value) of DT was held directly or indirectly by USS (the corporation that after the acquisition, and taking into account all transactions related to the acquisition, is the common parent of the EAG). The requirement set forth in §1.7874-1(c)(2)(ii) is satisfied because after the acquisition, and taking into account all transactions related to the acquisition, 80 percent or more of the stock (by vote and value) of FA (the foreign acquiring corporation) is held directly or

indirectly by USS. Therefore, the 100 FA shares are excluded from the numerator, but included in the denominator, of the ownership fraction. Accordingly, the ownership fraction is 0/100.

Example 3. U.S.-parented group exception available--(i) Facts. USP, a domestic corporation wholly owned by Individual A, owns all the stock of USS, a domestic corporation, and USS owns all the stock of DT, also a domestic corporation. DT owns all the stock of FT, a foreign corporation. The FT stock represents substantially all of the property of DT for purposes of section 7874. Pursuant to a divisive reorganization described in section 368(a)(1)(D), DT transfers all the FT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to USS pursuant to section 361(c)(1). In a related transaction, USS distributes all the FA stock to USP under section 355(c)(1). Lastly, in another related transaction and pursuant to a divisive reorganization described in section 368(a)(1)(D), USP transfers all the stock of USS and FA to DP, a newly formed domestic corporation, in exchange for all the stock of DP and distributes the DP stock to Individual A pursuant to section 361(c)(1).

(ii) Analysis. The 100 FA shares received by USS are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874-5T(a), the shares retain their status as such even though USS subsequently transfers the shares to USP. Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874-1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section applies. The requirement set forth in paragraph (c)(1)(i) of this section is satisfied because before the DT acquisition, USS (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent (the USP group). The requirement set forth in paragraph (c)(1)(ii) of this section is satisfied because after the DT acquisition, and taking into account all transactions related to the acquisition, each of USS, DP (the person that holds the transferred stock) , and FA (the foreign acquiring corporation) are members of a U.S.-parented group of which DP (a corporation that was formed in a transaction related to the DT acquisition and that, immediately after it was formed (but without regard to any related transactions) was a member of the USP group) is the common parent. Therefore, the 100 FA shares are excluded from the numerator and the denominator of the ownership fraction. Accordingly, the ownership fraction is 0/0.

Example 4. Foreign-parented group exception--(i) Facts. Individual A owns all the stock of FT, a foreign corporation, and FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all the stock of DT to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT



acquisition) and distributes the FA stock to Individual A in liquidation pursuant to section 361(c)(1).

(ii) Analysis. The 100 FA shares received by FT are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874-5T(a), the shares retain their status as such even though FT subsequently distributes the shares to Individual A pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG of purposes of applying section 7874(a)(2)(A) and §1.7874-1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874-1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The foreign-parented group exception described in paragraph (c)(2) of this section applies. The requirement set forth in paragraph (c)(2)(i) of this section is satisfied because before the DT acquisition, FT (the transferring corporation) and DT are members of the foreign-parented group of which FT is the common parent. The requirement set forth in paragraph (c)(2)(ii) of this section is satisfied because after the acquisition, and taking into account all transactions related to the acquisition, FT would be a member of the EAG absent the distribution of the FA shares pursuant to section 361(c)(1). Moreover, the DT acquisition qualifies as an internal group restructuring under §1.7874-1(c)(2). The requirement set forth in §1.7874-1(c)(2)(i) is satisfied because before the acquisition, 80 percent or more of the stock (by vote and value) of DT was held directly or indirectly by FT, the corporation that, without regard to the distribution of the FA shares pursuant to section 361(c)(1), would be common parent of the EAG after the acquisition. See §1.7874-1T(c)(2)(iii). The requirement set forth in §1.7874-1(c)(2)(ii) is satisfied because after the acquisition, but without regard to the distribution of the FA shares pursuant to the section 361(c)(1) distribution, FT would directly or indirectly hold 80 percent or more of the stock (by vote and value) of FA (the foreign acquiring corporation). See §1.7874-1T(c)(2)(iii). Therefore, the 100 FA shares are excluded from the numerator, but included in the denominator, of the ownership fraction. Accordingly, the ownership fraction is 0/100.

(iii) Alternative facts. The facts are the same as in paragraph (i) of this Example 4, except that in a transaction after and related to the DT acquisition, FA issues 200 shares of FA stock to Individual B in exchange for qualified property (within the meaning of §1.7874-4T(i)(7)). The foreign-parented group exception does not apply because after the acquisition, and taking into account FA's issuance of the 200 FA shares to Individual B, FT would not be a member of the EAG absent FT's distribution of the 100 FA shares pursuant to section 361(c)(1). Accordingly, the 100 FA shares received by FT are not treated as held by a member of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1. As a result, the ownership fraction is 100/300.

(h) Applicability dates. Except as otherwise provided in this paragraph (h), this section applies to domestic entity acquisitions completed on or after September 22,

2014. Paragraphs (d)(2) and (f)(2)(ii) of this section apply to domestic entity acquisitions completed on or after **April 4, 2016**. Taxpayers, however, may elect either to apply paragraph (c)(2) of this section to domestic entity acquisitions completed before September 22, 2014, or to consistently apply paragraphs (c)(2), (d)(2), and (f)(2)(ii) of this section and §1.7874-1(c)(2)(iii) and (f) to domestic entity acquisitions completed before **April 4, 2016**.

(i) Expiration date. This section expires on **April 4, 2019**.

Par. 19. Section 1.7874-7T is added to read as follows:

§1.7874-7T Disregard of certain stock attributable to passive assets (temporary).

(a) Scope. This section identifies certain stock of a foreign acquiring corporation that is attributable to passive assets and that is disregarded in determining the ownership fraction. Paragraph (b) of this section sets forth the general rule regarding when stock of a foreign acquiring corporation is excluded from the denominator of the ownership fraction under this section. Paragraph (c) of this section provides a de minimis exception to the application of the general rule of paragraph (b) of this section. Paragraph (d) of this section provides rules for the treatment of partnerships, and paragraph (e) of this section provides rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and §1.7874-1. Paragraph (f) of this section provides definitions. Paragraph (g) of this section provides examples illustrating the application of the rules of this section. Paragraph (h) of this section provides dates of applicability, and paragraph (i) of this section provides the date of expiration.

(b) General rule. If, on the completion date, more than fifty percent of the gross value of all foreign group property constitutes foreign group nonqualified property, then stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the product of--

(1) The value of the stock of the foreign acquiring corporation, other than stock that is described in section 7874(a)(2)(B)(ii) and stock that is excluded from the denominator of the ownership fraction under either §1.7874-1(b) or §1.7874-4T(b); and

(2) The foreign group nonqualified property fraction.

(c) De minimis ownership. Paragraph (b) of this section does not apply if--

(1) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§1.7874-4T(b) and 1.7874-10T(b), is less than five (by vote and value); and

(2) On the completion date, former domestic entity shareholders or former domestic entity partners, as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group.

(d) Treatment of partnerships. For purposes of this section, if one or more members of the modified expanded affiliated group own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership is treated as a corporation that is a member of the modified expanded affiliated group.

(e) Interaction with expanded affiliated group rules. Stock that is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section is

taken into account for purposes of determining whether an entity is a member of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and determining whether an acquisition qualifies as an internal group restructuring or results in a loss of control, as described in §1.7874-1(c)(2) and (3), respectively. However, such stock is excluded from the denominator of the ownership fraction for purposes of section 7874(a)(2)(B)(ii) regardless of whether it would otherwise be included in the denominator of the ownership fraction as a result of the application of §1.7874-1(c).

(f) Definitions. In addition to the definitions provided in §1.7874-12T, the following definitions apply for purposes of this section.

(1) Foreign group nonqualified property--(i) General rule. Foreign group nonqualified property means foreign group property described in §1.7874-4T(i)(7), other than the following:

(A) Property that gives rise to income described in section 954(h), determined--

(1) In the case of property held by a foreign corporation, by substituting the term “foreign corporation” for the term “controlled foreign corporation;” and

(2) In the case of property held by a domestic corporation, by substituting the term “domestic corporation” for the term “controlled foreign corporation,” without regard to the phrase “other than the United States” in section 954(h)(3)(A)(ii)(I), and without regard to any inference that the tests in section 954(h) should be calculated or determined without taking transactions with customers located in the United States into account.

(B) Property that gives rise to income described in section 954(i), determined by substituting the term “foreign corporation” for the term “controlled foreign corporation.”

(C) Property that gives rise to income described in section 1297(b)(2)(A) or (B).

(D) Property held by a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Internal Revenue Code, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business.

(ii) Special rule. Foreign group nonqualified property also means any foreign group property that, in a transaction related to the acquisition, is acquired in exchange for other property, including cash, if such other property would be described in paragraph (f)(1)(i) of this section had the transaction not occurred.

(2) Foreign group property means any property (including property that gives rise to stock that is excluded from the ownership fraction under §1.7874-4T(b)) held on the completion date by the modified expanded affiliated group, other than--

(i) Property that is directly or indirectly acquired in the domestic entity acquisition;

(ii) Stock or a partnership interest in a member of the modified expanded affiliated group; and

(iii) An obligation of a member of the modified expanded affiliated group.

(3) Foreign group nonqualified property fraction means a fraction calculated with the following numerator and denominator:

(i) The numerator of the fraction is the gross value of all foreign group nonqualified property, other than property received by the expanded affiliated group that gives rise to stock that is excluded from the ownership fraction under §1.7874-4T(b).

(ii) The denominator of the fraction is the gross value of all foreign group property, other than property received by the expanded affiliated group that gives rise to stock that is excluded from the ownership fraction under §1.7874-4T(b).

(4) Modified expanded affiliated group means, with respect to a domestic entity acquisition, the group described in either paragraph (f)(4)(i) of this section or paragraph (f)(4)(ii) of this section. A member of the modified expanded affiliated group is an entity included in the modified expanded affiliated group.

(i) When the foreign acquiring corporation is not the common parent corporation of the expanded affiliated group, the expanded affiliated group determined as if the foreign acquiring corporation was the common parent corporation.

(ii) When the foreign acquiring corporation is the common parent corporation of the expanded affiliated group, the expanded affiliated group.

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

Example 1. Application of general rule--(i) Facts. Individual A owns all 20 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 76 shares of newly issued FA stock (DT acquisition). In a transaction related to the DT acquisition, FA issues 4 shares of stock to Individual A in exchange for Asset A, which has a gross value of \$50x. On the completion date, in addition to the DT stock and Asset A, FA holds Asset B, which has a gross value of \$150x, and Asset C, which has a gross value of \$100x. Assets A and B, but not Asset C, are nonqualified property (within the meaning of §1.7874-4T(i)(7)). Further, Asset C was not acquired in a transaction related to the DT acquisition.

(ii) Analysis. The 4 shares of FA stock issued to Individual A in exchange for Asset A are disqualified stock under §1.7874-4T(c) and are excluded from the denominator of the ownership fraction pursuant to §1.7874-4T(b). Furthermore, additional shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section. This is because on the completion date, the gross value of all foreign group property is \$300x (the sum of the gross values of Assets A, B, and C), the gross value of all foreign group nonqualified property is \$200x (the sum of the gross values of Assets A and B), and thus 66.67% of the gross value of all foreign group property constitutes foreign group nonqualified property ( $\$200x/\$300x$ ). Because FA has only one class of stock outstanding, the shares of FA

stock that are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section are calculated by multiplying 20 shares of FA stock (100 shares less the 76 shares described in section 7874(a)(2)(B)(ii) and the 4 shares of disqualified stock) by the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is \$150x (the gross value of Asset B) and the denominator is \$250x (the sum of the gross values of Assets B and C). Accordingly, 12 shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section (20 shares multiplied by \$150x/\$250x). Thus, a total of 16 shares are excluded from the denominator of the ownership fraction (4 + 12). As a result, the ownership fraction is 76/84.

Example 2. Application of de minimis exception--(i) Facts. Individual A owns all 96 shares of the sole class of stock of FA, a foreign corporation. Individual B wholly owns DT, a domestic corporation. Individuals A and B are not related. FA acquires all the stock of DT solely in exchange for 4 shares of newly issued FA stock (DT acquisition). On the completion date, in addition to all of the stock of DT, FA holds Asset A, which is nonqualified property (within the meaning of §1.7874-4T(i)(7)).

(ii) Analysis. Without regard to the application of §1.7874-4T(b) and paragraph (b) of this section, the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA stock held by Individual B by reason of owning the DT stock, determined under §1.7874-2(f)(2), over 100 shares of FA stock outstanding after the DT acquisition). Furthermore, on the completion date, Individual B owns less than 5% (by vote and value) of the stock of FA and DT (the members of the expanded affiliated group). Accordingly, the de minimis exception in paragraph (c) of this section applies. Therefore, paragraph (b) of this section does not apply and the ownership fraction is 4/100.

Example 3. Foreign acquiring corporation not common parent of EAG--(i) Facts. FP, a foreign corporation, owns all 85 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). On the completion date, FA, in addition to all of the stock of DT, owns Asset A, which has a gross value of \$40x, and Asset B, which has a gross value of \$45x. Moreover, on the completion date, in addition to the 85 shares of FA stock, FP owns Asset C, which has a gross value of \$10x. Assets A and C, but not Asset B, are nonqualified property (within the meaning of §1.7874-4T(i)(7)). Further, Asset B was not acquired in a transaction related to the DT acquisition in exchange for nonqualified property.

(ii) Analysis. Under paragraph (f)(2) of this section, Assets A and B, but not Asset C, are foreign group property. Although Asset C is held on the completion date by FP, a member of the expanded affiliated group, Asset C is not foreign group property because FP is not a member of the modified expanded affiliated group. This is the case because if the expanded affiliated group were determined based on FA as the common parent corporation, FP would not be a member of such expanded affiliated group (see paragraph (f)(4)(i) of this section). Under paragraph (f)(1) of this section, Asset A, but

not Asset B, is foreign group nonqualified property. Therefore, on the completion date, the gross value of all foreign group property is \$85x (the sum of the gross values of Assets A and B), and the gross value of all foreign group nonqualified property is \$40x (the gross value of Asset A). Accordingly, on the completion date, only 47.06% of the gross value of all foreign group property constitutes foreign group nonqualified property ( $\$40x/\$85x$ ). Consequently, paragraph (b) of this section does not apply to exclude any FA stock from the denominator of the ownership fraction.

(h) Applicability dates. Except as otherwise provided in this paragraph (h), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraphs (c), (d), and (f)(2) and (4) of this section apply to domestic entity acquisitions completed on or after **April 4, 2016**. Paragraphs (f)(1)(i)(A)(2) and (f)(1)(i)(D) of this section, as well as the portion of paragraph (f)(1)(i)(C) of this section relating to property that gives rise to income described in section 1297(b)(2)(B), apply to domestic entity acquisitions completed on or after November 19, 2015. For domestic entity acquisitions completed on or after September 22, 2014, and before **April 4, 2016**, however, taxpayers may elect to apply paragraphs (c), (d), and (f)(2) and (4) of this section. In addition, for domestic entity acquisitions completed on or after September 22, 2014, and before **April 4, 2016**, taxpayers may elect to apply paragraph (f)(2) of this section by substituting the term “expanded affiliated group” for the term “modified expanded affiliated group.” Furthermore, for domestic entity acquisitions completed on or after September 22, 2014, and before November 19, 2015, taxpayers may elect to apply paragraphs (f)(1)(i)(A)(2) and (f)(1)(i)(D) of this section, as well as the portion of paragraph (f)(1)(i)(C) of this section relating to property that gives rise to income described in section 1297(b)(2)(B).

(i) Expiration date. The applicability of this section expires on **April 4, 2019**.

Par. 20. Section 1.7874-8T is added to read as follows:



§1.7874-8T Disregard of certain stock attributable to multiple domestic entity acquisitions (temporary).

(a) Scope. This section identifies stock of a foreign acquiring corporation that is disregarded in determining an ownership fraction by value because it is attributable to certain prior domestic entity acquisitions. Paragraph (b) of this section sets forth the general rule regarding the amount of stock of a foreign acquiring corporation that is excluded from the denominator of the ownership fraction by value under this section, and paragraphs (c) through (f) of this section provide rules for determining this amount. Paragraph (g) provides definitions. Paragraph (h) of this section provides examples illustrating the application of the rules of this section. Paragraph (i) of this section provides dates of applicability, and paragraph (j) of this section provides the date of expiration. This section applies after taking into account §1.7874-2(e).

(b) General rule. This paragraph (b) applies to a domestic entity acquisition (relevant domestic entity acquisition) when the foreign acquiring corporation (including a predecessor) has completed one or more prior domestic entity acquisitions. When this paragraph (b) applies, then, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class.

(c) Computation of excluded amounts. With respect to each prior domestic entity acquisition and each relevant share class, the excluded amount is the product of--

(1) The total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all redemption testing periods; and

(2) The fair market value of a single share of stock of the relevant share class on the completion date of the relevant domestic entity acquisition.

(d) Computation of allocable redeemed shares--(1) In general. With respect to each prior domestic entity acquisition and each relevant share class, the allocable redeemed shares, determined separately for each redemption testing period, is the product of the number of redeemed shares during the redemption testing period and the redemption fraction.

(2) Redemption fraction. The redemption fraction is determined separately with respect to each prior domestic entity acquisition, each relevant share class, and each redemption testing period, as follows:

(i) The numerator is the total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all prior redemption testing periods.

(ii) The denominator is the sum of--

(A) The number of outstanding shares of the foreign acquiring corporation stock as of the end of the last day of the redemption testing period; and

(B) The number of redeemed shares during the redemption testing period.

(e) Rules for determining redemption testing periods--(1) In general. Except as provided in paragraph (e)(2) of this section, a redemption testing period with respect to a prior domestic entity acquisition is the period beginning on the day after the completion date of the prior domestic entity acquisition and ending on the day prior to the completion date of the relevant domestic entity acquisition.

(2) Election to use multiple redemption testing periods. A foreign acquiring corporation may establish a reasonable method for dividing the period described in paragraph (e)(1) of this section into shorter periods (each such shorter period, a redemption testing period). A reasonable method would include a method based on a calendar convention (for example, daily, monthly, quarterly, or yearly), or on a convention that triggers the start of a new redemption testing period whenever a share issuance occurs that exceeds a certain threshold. In order to be reasonable, the method must be consistently applied with respect to all prior domestic entity acquisitions and all relevant share classes.

(f) Appropriate adjustments required to take into account share splits and similar transactions. For purposes of this section, appropriate adjustments must be made to take into account changes in a foreign acquiring corporation's capital structure, including, for example, stock splits, reverse stock splits, stock distributions, recapitalizations, and similar transactions. Thus, for example, in determining the total number of prior acquisition shares with respect to a relevant share class, appropriate adjustments must be made to take into account a stock split with respect to that relevant share class that occurs after the completion date with respect to a prior domestic entity acquisition.

(g) Definitions. In addition to the definitions provided in §1.7874-12T, the following definitions apply for purposes of this section.

(1) A binding contract means an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) does not prevent an

instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, does not prevent an instrument from being a binding contract. A tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934, (15 U.S.C. 78n(d)(1)), and Regulation 14D (17 CFR 240.14d-1 through 240.14d-103) and that is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees.

(2) A relevant share class means, with respect to a prior domestic entity acquisition, each separate legal class of shares in the foreign acquiring corporation from which prior acquisition shares were issued. See also paragraph (f) of this section (requiring appropriate adjustments in certain cases).

(3) Total number of prior acquisition shares means, with respect to a prior domestic entity acquisition and each relevant share class, the total number of shares of stock of the foreign acquiring corporation that were described in section 7874(a)(2)(B)(ii) as a result of that acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied), adjusted as appropriate under paragraph (f) of this section.

(4) A prior domestic entity acquisition--(i) General rule. Except as provided in this paragraph (g)(4), a prior domestic entity acquisition means, with respect to a relevant domestic entity acquisition, a domestic entity acquisition that occurred within the 36-month period ending on the signing date of the relevant domestic entity acquisition.

(ii) Exception. A domestic entity acquisition is not a prior domestic entity acquisition if--

(A) The ownership percentage described in section 7874(a)(2)(B)(ii) with respect to the domestic entity acquisition was less than five (by vote and value); and

(B) The fair market value of the stock of the foreign acquiring corporation that was described in section 7874(a)(2)(B)(ii) as a result of the domestic entity acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied) did not exceed \$50 million, as determined on the completion date with respect to the domestic entity acquisition.

(5) A redeemed share means a share of stock in a relevant share class that was redeemed (within the meaning of section 317(b)).

(6) A signing date means the first date on which the contract to effect the relevant domestic entity acquisition is a binding contract, or if another binding contract to effect a substantially similar acquisition was terminated with a principal purpose of avoiding section 7874, the first date on which such other contract was a binding contract.

(h) Examples. The following examples illustrate the rules of this section.

Example 1. Application of general rule--(i) Facts. Individual A wholly owns DT1, a domestic corporation. Individual B owns all 100 shares of the sole class of stock of FA, a foreign corporation. In Year 1, FA acquires all the stock of DT1 solely in exchange for 100 shares of newly issued FA stock (DT1 acquisition). On the completion date with respect to the DT1 acquisition, the fair market value of each share of FA stock is \$1x. In Year 3, FA enters into a binding contract to acquire all the stock of DT2, a domestic corporation wholly owned by Individual C. Thereafter, FA acquires all the stock of DT2 solely in exchange for 150 shares of newly issued FA stock (DT2 acquisition). On the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is \$1.50x. FA did not complete the DT1 acquisition and DT2 acquisition pursuant to a plan (or series of related transactions) for purposes of applying §1.7874-2(e). In addition, there have been no redemptions of FA stock subsequent to the DT1 acquisition.

(ii) Analysis. The DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition) because the DT1 acquisition occurred within the 36-month period ending on the signing date with respect to the DT2 acquisition. Accordingly, paragraph (b) of this section applies to the DT2 acquisition. As a result, and because there were no redemptions of FA stock, the excluded amount is \$150x (calculated as 100, the total number of prior acquisition shares, multiplied by \$1.50x, the fair market value of a single class of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is \$225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)). In addition, the denominator of the ownership fraction is \$375x (calculated as \$525x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less \$150x, the excluded amount). Therefore, the ownership percentage by value is 60.

Example 2. Effect of certain redemptions--(i) Facts. The facts are the same as in paragraph (i) of Example 1 of this paragraph (h), except that in Year 2 FA redeems 50 shares of its stock (the Year 2 redemption).

(ii) Analysis. As is the case in paragraph (ii) of Example 1 of this paragraph (h), the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition), and paragraph (b) of this section thus applies to the DT2 acquisition. Because of the Year 2 redemption, the allocable redeemed shares, and thus the redemption fraction, must be calculated. For this purpose, the redemption testing period is the period beginning on the day after the completion date with respect to the DT1 acquisition and ending on the day prior to the completion date with respect to the DT2 acquisition. The redemption fraction for the redemption testing period is thus  $100/200$ , calculated as 100 (the total number of prior acquisition shares) divided by 200 (150, the number of outstanding shares of FA stock on the last day of the redemption testing period, plus 50, the number of redeemed shares during the redemption testing period), and the allocable redeemed shares for the redemption testing period is 25, calculated as 50 (the number of redeemed shares during the redemption testing period) multiplied by  $100/200$  (the redemption fraction for the redemption testing period). As a result, the excluded amount is \$112.50x, calculated as 75 (100, the total number of prior acquisition shares, less 25, the allocable redeemed shares) multiplied by \$1.50x, the fair market value of a single share of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is \$225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)), and the denominator of the ownership fraction is \$337.50x (calculated as \$450x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less \$112.50x, the excluded amount). Therefore, the ownership percentage by value is 66.67.

Example 3. Stock split--(i) Facts. The facts are the same as in paragraph (i) of Example 2 of this paragraph (h), except as follows. After the Year 2 redemption, but

before the DT2 acquisition, FA undergoes a stock split and, as a result, each of the 150 shares of FA stock outstanding are converted into two shares (Year 2 stock split). Further, pursuant to the DT2 acquisition, FA acquires all the stock of DT2 solely in exchange for 300 shares of newly issued FA stock. Moreover, on the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is \$0.75x.

(ii) Analysis. As is the case in paragraph (ii) of Example 1 of this paragraph (h), the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition), and paragraph (b) of this section thus applies to the DT2 acquisition. In addition, as is the case in paragraph (ii) of Example 2 of this paragraph (h), the redemption testing period is the period beginning on the day after the completion date with respect to the DT1 acquisition and ending on the day prior to the completion date with respect to the DT2 acquisition. To calculate the redemption fraction, the total number of prior acquisition shares and the number of redeemed shares during the redemption testing period must be appropriately adjusted to take into account the Year 2 stock split. See paragraph (f) of this section. In this case, the appropriate adjustment is to increase the total number of prior acquisition shares from 100 to 200 and to increase the number of redeemed shares during the redemption testing period from 50 to 100. Thus, the redemption fraction for the redemption testing period is  $200/400$ , calculated as 200 (the total number of prior acquisition shares) divided by 400 (300, the number of outstanding shares of FA stock on the last day of the redemption testing period, plus 100, the number of redeemed shares during the redemption testing period), and the allocable redeemed shares for the redemption testing period is 50, calculated as 100 (the number of redeemed shares during the redemption testing period) multiplied by  $200/400$  (the redemption fraction for the redemption testing period). In addition, for purposes of calculating the excluded amount, the total number of prior acquisition shares must be adjusted from 100 to 200. See paragraph (f) of this section. Accordingly, the excluded amount is \$112.50x, calculated as 150 (200, the total number of prior acquisition shares, less 50, the allocable redeemed shares) multiplied by \$0.75x, the fair market value of a single class of FA stock on the completion date with respect to the DT2 acquisition). Consequently, the numerator of the ownership fraction by value is \$225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)), and the denominator of the ownership fraction is \$337.50x (calculated as \$450x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less \$112.50x, the excluded amount). Therefore, the ownership percentage by value is 66.67.

(i) Applicability dates. This section applies to domestic entity acquisitions completed on or after **April 4, 2016**, regardless of when a prior domestic entity acquisition was completed.

(j) Expiration date. The applicability of this section expires on **April 4, 2019**.

Par. 21. Section 1.7874-9T is added to read as follows:

§1.7874-9T Disregard of certain stock in third-country transactions (temporary).

(a) Scope. This section identifies certain stock of a foreign acquiring corporation that is disregarded in determining the ownership fraction. Paragraph (b) of this section provides a rule that, in a third-country transaction, excludes from the denominator of the ownership fraction stock in the foreign acquiring corporation held by former shareholders of an acquired foreign corporation by reason of holding certain stock in that foreign corporation. Paragraph (c) of this section defines a third-country transaction, and paragraph (d) of this section provides other definitions. Paragraph (e) of this section provides operating rules. Paragraph (f) of this section provides an example illustrating the application of the rules of this section. Paragraph (g) of this section provides the dates of applicability, and paragraph (h) of this section provides the date of expiration.

(b) Exclusion of certain stock of a foreign acquiring corporation from the ownership fraction. When a domestic entity acquisition is a third-country transaction, stock of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (within the meaning of paragraph (e)(4) of this section) is, to the extent the stock otherwise would be included in the denominator of the ownership fraction, excluded from the denominator of the ownership fraction pursuant to this paragraph.

(c) Third-country transaction. A domestic entity acquisition is a third-country transaction if the following requirements are satisfied:



(1) The foreign acquiring corporation completes a covered foreign acquisition pursuant to a plan (or series of related transactions) that includes the domestic entity acquisition.

(2) After the covered foreign acquisition and all related transactions are complete, the foreign acquiring corporation is not subject to tax as a resident in the foreign country in which the acquired foreign corporation was subject to tax as a resident before the covered foreign acquisition and all related transactions.

(3) The ownership percentage, determined without regard to the application of paragraph (b) of this section, is at least 60.

(d) Definitions. In addition to the definitions provided in §1.7874-12T, the following definitions apply for purposes of this section.

(1) A foreign acquisition means a transaction in which a foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an acquired foreign corporation (within the meaning of paragraph (e)(2) of this section).

(2) An acquired foreign corporation means a foreign corporation whose properties are acquired in a foreign acquisition.

(3) Foreign ownership percentage means, with respect to a foreign acquisition, the percentage of stock (by vote or value) of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (within the meaning of paragraph (e)(3) of this section).

(4) Covered foreign acquisition means a foreign acquisition in which, after the acquisition and all related transactions are complete, the foreign ownership percentage is at least 60.

(e) Operating rules. The following rules apply for purposes of this section.

(1) Acquisition of multiple foreign corporations that are tax residents of the same foreign country. When multiple foreign acquisitions occur pursuant to a plan (or series of related transactions) and two or more of the acquired foreign corporations were subject to tax as a resident of the same foreign country before the foreign acquisitions and all related transactions, then those foreign acquisitions are treated as a single foreign acquisition and those acquired foreign corporations are treated as a single acquired foreign corporation for purposes of this section.

(2) Acquisition of properties of an acquired foreign corporation. For purposes of determining whether a foreign acquisition occurs, the principles of section 7874(a)(2)(B)(i) and §1.7874-2(c) and (d) (regarding acquisitions of properties of a domestic entity and acquisitions by multiple foreign corporations) apply with the following modifications:

(i) The principles of §1.7874-2(c)(1) (providing rules for determining whether there is an indirect acquisition of properties of a domestic entity), including §1.7874-2(b)(5) (providing rules for determining the proportionate amount of properties indirectly acquired), apply by substituting the term “foreign” for “domestic” wherever it appears.

(ii) The principles of §1.7874-2(c)(2) (regarding acquisitions of stock of a foreign corporation that owns a domestic entity) apply by substituting the term “domestic” for “foreign” wherever it appears.

(3) Computation of foreign ownership percentage. For purposes of determining a foreign ownership percentage, the principles of all rules applicable to calculating an ownership percentage apply (including section 7874(c)(4) and §§1.7874-2, 1.7874-2T, 1.7874-4T, 1.7874-5T, and 1.7874-7T) with the following modifications:

(i) Stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) is not taken into account.

(ii) The principles of this section, section 7874(c)(2)(A), and §§1.7874-1, 1.7874-6T, 1.7874-8T, and 1.7874-10T do not apply.

(iii) The principles of §1.7874-7T apply by, in addition to the exclusions listed in §1.7874-7T(f)(2)(i) through (iii), also excluding from the definition of foreign group property any property held directly or indirectly by the acquired foreign corporation immediately before the foreign acquisition and directly or indirectly acquired in the foreign acquisition.

(4) Stock held by reason of holding stock in an acquired foreign corporation. For purposes of determining stock of a foreign acquiring corporation held by reason of holding stock in an acquired foreign corporation, the principles of section 7874(a)(2)(B)(ii) and §§1.7874-2(f), 1.7874-2T(f), and 1.7874-5T apply.

(5) Change in the tax residency of a foreign corporation. For purposes of this section, a change in a country in which a foreign corporation is subject to tax as a resident is treated as a transaction. Thus, for example, a change in the location of the management and control of an acquired foreign corporation that results in a change in a country in which the acquired foreign corporation is subject to tax as a resident would be treated as a transaction.

(f) Example. The following example illustrates the rules of this section.

Example. Third-country transaction--(i) Facts. FA, a newly formed foreign corporation that is subject to tax as a resident of Country Y, acquires all the stock of DT, a domestic corporation that is wholly owned by Individual A, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). Pursuant to a plan that includes the DT acquisition, FA acquires all the stock of FT, a foreign corporation that is subject to tax as a resident of Country X and wholly owned by Individual B, solely in exchange for the remaining 35 shares of newly issued FA stock (FT acquisition).

(ii) Analysis. As described in paragraphs (A) through (C) of this Example, the requirements set forth in paragraphs (c)(1) through (3) of this section are satisfied and, as result, the DT acquisition is a third-country transaction.

(A) The FT acquisition is a foreign acquisition because, pursuant to the FT acquisition, FA (a foreign corporation) acquires 100 percent of the stock of FT and is thus treated as indirectly acquiring 100 percent of the properties held by FT (an acquired foreign corporation). See §1.7874-2(c)(1) and paragraph (e)(2) of this section. Moreover, Individual B is treated as receiving 35 shares of FA stock by reason of holding stock in FT. See §1.7874-2(f)(1)(i) and paragraph (e)(4) of this section. As a result, not taking into account the 65 shares of FA stock held by Individual A (a former domestic entity shareholder), 100 percent (35/35) of the stock of FA is held by reason of holding stock in FT and, thus, the foreign ownership percentage is 100. See paragraph (e)(3) of this section. Accordingly, the FT acquisition is a covered foreign acquisition. Therefore, because the FT acquisition occurs pursuant to a plan that includes the DT acquisition, the requirement set forth in paragraph (c)(1) of this section is satisfied.

(B) The requirement set forth in paragraph (c)(2) of this section is satisfied because, after the FT acquisition and all related transactions, the foreign country in which FA is subject to tax as a resident (Country Y) is different than the foreign country in which FT was subject to tax as a resident (Country X) before the FT acquisition and all related transactions.

(C) The requirement set forth in paragraph (c)(3) of this section is satisfied because, not taking into account paragraph (b) of this section, the ownership fraction is 65/100 and the ownership percentage is 65.

(D) Because the DT acquisition is a third-country transaction, the 35 shares of FA stock held by reason of holding stock in FT are excluded from the denominator of the ownership fraction. See paragraph (b) of this section. As a result, the ownership fraction is 65/65 and the ownership percentage is 100. The result would be the same if instead FA had directly acquired all of the properties held by FT in exchange for FA stock, for example, in a transaction that would qualify for U.S. federal income tax purposes as an asset reorganization under section 368.

(iii) Alternative facts. The facts are the same as in paragraph (i) of this example, except that before the FT acquisition, but in a transaction related to the FT acquisition, FT becomes subject to tax as a resident of Country Y by reincorporating in Country Y. As is the case in paragraph (ii) of this Example, the requirements set forth in paragraphs (c)(1) and (3) of this section are satisfied. The requirement set forth in paragraph (c)(2) of this section is satisfied because, after the FT acquisition and any related transactions, the foreign country of which FA is subject to tax as a resident (Country Y) is different than the foreign country of which FT was subject to tax as a resident (Country X) before the FT acquisition and the reincorporation. See paragraph (e)(5) of this section. Accordingly, the DT acquisition is a third-country transaction and the consequences are the same as in paragraph (ii)(D) of this Example.

(iv) Alternative facts. The facts are the same as in paragraph (i) of this Example, except that, instead of FA acquiring all of the stock of FT, FS, a newly formed foreign corporation that is wholly owned by FA and that is subject to tax as a resident of Country X, acquires all the stock of FT solely in exchange for 35 shares of newly issued FA stock (FT acquisition). As a result of the FT acquisition, FS and FA are each treated as indirectly acquiring 100 percent of the properties held by FT. See §1.7874-2(c)(1)(i) and (iii) and paragraph (e)(2) of this section. Accordingly, each of FS's and FA's indirect acquisition of properties of FT (an acquired foreign corporation) is a foreign acquisition. However, FS's indirect acquisition of FT's properties is not a covered foreign acquisition because no shares of FS stock are held by reason of holding stock in FT; thus, with respect to this foreign acquisition, the foreign ownership percentage is zero. See §1.7874-2(f) and paragraphs (e)(3) and (4) of this section. FA's indirect acquisition of FT's properties is a covered foreign acquisition because 35 shares of FA stock (the shares received by Individual B) are held by reason of holding stock in FT; thus, the foreign ownership percentage is 100 percent (100/100). See §1.7874-2(f)(1)(i) and paragraphs (e)(3) and (4) of this section. Accordingly, because the FT acquisition occurs pursuant to a plan that includes the DT acquisition, the requirement set forth in paragraph (c)(1) of this section is satisfied. Further, as is the case in paragraphs (ii)(B) through (C) of this Example, the requirements set forth in paragraphs (c)(2) and (3) of this section are satisfied. Therefore, the DT acquisition is a third-country transaction and the consequences are the same as in paragraph (ii)(D) of this Example.

(g) Applicability dates. Except as otherwise provided in this paragraph (g), this section applies to domestic entity acquisitions completed on or after November 19, 2015. For domestic entity acquisitions completed on or after November 19, 2015, and before **April 4, 2016**, however, in lieu of applying paragraphs (d)(3) and (4) of this section, taxpayers may elect to define a covered foreign acquisition as a foreign acquisition in which the gross value of all property directly or indirectly acquired by the

foreign acquiring corporation in the foreign acquisition exceeds 60 percent of the gross value of all foreign group property (as defined in §1.7874-7T(f)(2), but substituting the term “expanded affiliated group” for the term “modified expanded affiliated group”), but, for this purpose, gross value shall not include any property that is foreign group nonqualified property (as defined in §1.7874-7T(f)(1)). In addition, for domestic entity acquisitions completed on or after November 19, 2015, and before **April 4, 2016**, taxpayers may elect to substitute the requirement of paragraph (c)(2) of this section with the requirement that the tax residence of the foreign acquiring corporation is not the same as that of the acquired foreign corporation, as determined before the foreign acquisition and any related transaction.

(h) Expiration date. The applicability of this section expires on **April 4, 2019**.

Par. 22. Section 1.7874-10T is added to read as follows:

§1.7874-10T Disregard of certain distributions (temporary).

(a) Scope. This section identifies distributions made by a domestic entity that are disregarded in determining an ownership fraction. Paragraph (b) of this section provides the general rule that former domestic entity shareholders or former domestic entity partners are treated as receiving additional stock of the foreign acquiring corporation when the domestic entity has made non-ordinary course distributions (NOCDs). Paragraph (c) of this section identifies distributions that, in whole or in part, are outside the scope of this section. Paragraph (d) of this section provides a de minimis exception to the application of the general rule in paragraph (b) of this section. Paragraph (e) of this section provides rules concerning the treatment of distributions made by a predecessor, and paragraph (f) of this section provides rules for identifying a

predecessor. Paragraph (g) of this section provides a special rule for certain distributions described in section 355. Paragraph (h) of this section provides definitions. Paragraph (i) of this section provides dates of applicability, and paragraph (j) of this section provides the date of expiration.

(b) General rule regarding NOCDs. Except as provided in paragraph (d) of this section, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), former domestic entity shareholders or former domestic entity partners, as applicable, are treated as receiving, by reason of holding stock or partnership interests in a domestic entity, stock of the foreign acquiring corporation with a fair market value equal to the amount of the non-ordinary course distributions (NOCDs), determined as of the date of the distributions, made by the domestic entity during the look-back period. The stock of the foreign acquiring corporation treated as received under this paragraph (b) is in addition to stock of the foreign acquiring corporation otherwise treated as received by the former domestic entity shareholders or former domestic entity partners by reason of holding stock or partnership interests in the domestic entity.

(c) Distributions that are not NOCDs. If only a portion of a distribution is an NOCD, section 7874(c)(4) may apply to the remainder of the distribution. This section does not, however, create a presumption that section 7874(c)(4) applies to the remainder of the distribution.

(d) De minimis exception to the general rule. Paragraph (b) of this section does not apply if--

(1) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§1.7874-4T(b) and 1.7874-7T(b), is less than five (by vote and value); and

(2) On the completion date, former domestic entity shareholders or former domestic entity partners, as applicable, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group (within the meaning of §1.7874-4T(i)(3)).

(e) Treatment of distributions made by a predecessor. For purposes of this section, a corporation or a partnership (relevant entity), including a domestic entity, is treated as making the following distributions made by a predecessor with respect to the relevant entity:

(1) A distribution made before the predecessor acquisition with respect to the predecessor; and

(2) A distribution made in connection with the predecessor acquisition to the extent the property distributed is directly or indirectly provided by the predecessor. See paragraph (h)(1)(iv) of this section.

(f) Rules for identifying a predecessor--(1) Definition of predecessor. A corporation or a partnership (tentative predecessor) is a predecessor with respect to a relevant entity if--

(i) The relevant entity completes a predecessor acquisition; and

(ii) After the predecessor acquisition and all related transactions are complete, the tentative predecessor ownership percentage is at least 10.



(2) Definition of predecessor acquisition--(i) In general. Predecessor acquisition means a transaction in which a relevant entity directly or indirectly acquires substantially all of the properties held directly or indirectly by a tentative predecessor.

(ii) Acquisition of properties of a tentative predecessor. For purposes of determining whether a predecessor acquisition occurs, the principles of section 7874(a)(2)(B)(i) apply, including §1.7874-2(c) other than §1.7874-2(c)(2) and (4) (regarding acquisitions of properties of a domestic entity), without regard to whether the tentative predecessor is domestic or foreign.

(iii) Lower-tier entities of a predecessor. If, before a predecessor acquisition and all related transactions, the predecessor held directly or indirectly stock in a corporation or an interest in a partnership, then, for purposes of this section, the relevant entity is not considered to directly or indirectly acquire the properties held directly or indirectly by the corporation or partnership.

(3) Definition of tentative predecessor ownership percentage. Tentative predecessor ownership percentage means, with respect to a predecessor acquisition, the percentage of stock or partnership interests (by value) in a relevant entity held by reason of holding stock or partnership interests in the tentative predecessor. For purposes of computing the tentative predecessor ownership percentage, the following rules apply:

(i) For purposes of determining the stock or partnership interests in a relevant entity held by reason of holding stock or partnership interests in the tentative predecessor, the principles of section 7874(a)(2)(B)(ii) and §§1.7874-2(f)(1)(i) through (iii) and 1.7874-5T apply.

(ii) For purposes of determining the stock or partnership interests in a relevant entity included in the numerator of the fraction used to compute the tentative predecessor ownership percentage, the rules of paragraph (f)(3)(i) of this section apply, and all the rules applicable to calculating the numerator of an ownership fraction with respect to a domestic entity acquisition apply, except that--

(A) The principles of section 7874(c)(2)(A) and §§1.7874-1 and 1.7874-6T do not apply; and

(B) The principles of paragraph (b) of this section do not apply.

(iii) For purposes of determining stock or partnership interests in a relevant entity included in the denominator of the fraction used to compute the tentative predecessor ownership percentage, the principles of section 7874(a)(2)(B)(ii) and all rules applicable to calculating the denominator of an ownership fraction with respect to a domestic entity acquisition apply, except that--

(A) The principles of section 7874(c)(2)(A) and §§1.7874-1 and 1.7874-6T do not apply; and

(B) The principles of §§1.7874-4T and 1.7874-7T through 1.7874-9T do not apply.

(g) Rule regarding direction of a section 355 distribution. For purposes of this section, if a domestic corporation (distributing corporation) distributes the stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355, and, immediately before the distribution, the fair market value of the stock of the controlled corporation represents more than 50 percent of the fair market value of the stock of the distributing corporation, then, the controlled corporation

is deemed, on the date of the distribution, to have distributed the stock of the distributing corporation. The deemed distribution is equal to the fair market value of the stock of the distributing corporation (but not taking into account the fair market value of the stock of the controlled corporation) on the date of the distribution.

(h) Definitions. In addition to the definitions provided in §1.7874-12T, the following definitions apply for purposes of this section.

(1) A distribution means the following:

(i) Any distribution made by a corporation with respect to its stock other than--

(A) A distribution to which section 305 applies;

(B) A distribution to which section 304(a)(1) applies; and

(C) Except as provided in paragraphs (h)(1)(iii) and (iv) of this section, a distribution pursuant to section 361(c)(1).

(ii) Any distribution by a partnership.

(iii) In the case of a domestic entity, a transfer of money or other property to the former domestic entity shareholders or former domestic entity partners that is made in connection with the domestic entity acquisition to the extent the money or other property is directly or indirectly provided by the domestic entity.

(iv) In the case of a predecessor, a transfer of money or other property to the former owners of the predecessor that is made in connection with the predecessor acquisition to the extent the money or other property is directly or indirectly provided by the predecessor.

(2) Distribution history period--(i) In general. Except as provided in paragraph (h)(2)(ii) or (iii) of this section, a distribution history period means, with respect to a look-back year, the 36-month period preceding the start of the look-back year.

(ii) Formation date less than 36 months but at least 12 months before look-back year. If the formation date is less than 36 months, but at least 12 months, before the start of a look-back year, then the distribution history period with respect to that look-back year means the entire period, starting with the formation date, that precedes the start of the look-back year.

(iii) Formation date less than 12 months before look-back year. If the formation date is less than 12 months before the start of a look-back year, then there is no distribution history period with respect to that look-back year.

(3) Formation date means, with respect to a domestic entity, the date that the domestic entity was created or organized, or, if earlier, the earliest date that any predecessor of the domestic entity was created or organized.

(4) Look-back period means, with respect to a domestic acquisition, the 36-month period ending on the completion date or, if shorter, the entire period, starting with the formation date, that ends on the completion date.

(5) Look-back year means, with respect to a look-back period, the following:

(i) If the look-back period is 36 months, the three consecutive 12-month periods that comprise the look-back period.

(ii) If the look-back period is less than 36 months, but at least 24 months--

(A) The 12-month period that ends on the completion date;

(B) The 12-month period that immediately precedes the period described in paragraph (h)(5)(ii)(A) of this section; and

(C) The period, if any, that immediately precedes the period described in paragraph (h)(5)(ii)(B) of this section.

(iii) If the look-back period is less than 24 months, but at least 12 months--

(A) The 12-month period that ends on the completion date; and

(B) The period, if any, that immediately precedes the period described in paragraph (h)(5)(iii)(A) of this section.

(iv) If the look-back period is less than 12 months, the entire period, starting with the formation date, that ends on the completion date.

(6) NOCDs mean, with respect to a look-back year, the excess of all distributions made during the look-back year over the NOCD threshold for the look-back year.

(7) NOCD threshold means, with respect to a look-back year, the following:

(i) If the look-back year has at least a 12-month distribution history period, 110 percent of the sum of all distributions made during the distribution history period multiplied by a fraction. The numerator of the fraction is the number of days in the look-back year and the denominator is the number of days in the distribution history period with respect to the look-back year.

(ii) If the look-back year has no distribution history period, zero.

(i) Applicability date. Except as otherwise provided in this paragraph (i), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraph (d) of this section applies to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (g) of this section applies to domestic entity

acquisitions completed on or after **April 4, 2016**. For domestic entity acquisitions completed on or after September 22, 2014, and before November 19, 2015, however, taxpayers may elect to apply paragraph (d) of this section. In addition, for domestic entity acquisitions completed on or after September 22, 2014, and before **April 4, 2016**, taxpayers may elect to determine NOCDs consistently on the basis of taxable years, in lieu of 12-month periods, in a manner consistent with the principles of this section. See paragraph (h)(5) of this section.

(j) Expiration date. This section expires on **April 4, 2019**.

Par. 23. Section 1.7874-11T is added to read as follows:

§1.7874-11T Rules regarding inversion gain (temporary).

(a) Scope. This section provides rules for determining the inversion gain of an expatriated entity for purposes of section 7874. Paragraph (b) of this section provides rules for determining the inversion gain of an expatriated entity. Paragraph (c) of this section provides special rules with respect to certain foreign partnerships in which an expatriated entity owns an interest. Paragraph (d) of this section provides additional definitions. Paragraph (e) of this section provides an example that illustrates the rules of this section. Paragraph (f) of this section provides the applicability dates, and paragraph (g) of this section provides the date of expiration.

(b) Inversion gain--(1) General rule. Except as provided in paragraphs (b)(2) and (3) of this section, inversion gain includes income (including an amount treated as a dividend under section 78) or gain recognized by an expatriated entity for any taxable year that includes any portion of the applicable period by reason of a direct or indirect transfer of stock or other properties or license of any property either as part of the

acquisition described in section 7874(a)(2)(B)(i), or after such acquisition if the transfer or license is to a specified related person.

(2) Exception for property described in section 1221(a)(1). Inversion gain does not include income or gain recognized by reason of the transfer or license, after the acquisition, of property that is described in section 1221(a)(1) in the hands of the transferor or licensor.

(3) Treatment of partnerships. Except to the extent provided in paragraph (c) of this section and section 7874(e)(2), inversion gain does not include income or gain recognized by reason of the transfer or license of property by a partnership.

(c) Transfers and licenses by partnerships. If a partnership that is a foreign related person transfers or licenses property, a partner of the partnership shall be treated as having transferred or licensed its proportionate share of that property, as determined under the rules and principles of sections 701 through 777, for purposes of determining the inversion gain of an expatriated entity. See section 7874(e)(2) for rules regarding the treatment of transfers and licenses by domestic partnerships and transfers of interests in certain domestic partnerships.

(d) Definitions. The definitions provided in §1.7874-12T apply for purposes of this section.

(e) Example. The following example illustrates the rules of this section.

Example--(i) Facts. On July 1, 2016, FA, a foreign corporation, acquires all the stock of DT, a domestic corporation, in an inversion transaction. When the inversion transaction occurred, DT wholly owned FS, a foreign corporation that is a controlled foreign corporation (within the meaning of section 957(a)). During the applicable period, FS sells to FA property that is not described in section 1221(a)(1) in the hands of FS. Under section 951(a)(1)(A), DT has a \$80x gross income inclusion that is attributable to FS's gain from the sale of the property. Under section 960(a)(1), DT is deemed to have paid \$20x of the post-1986 foreign income taxes of FS by reason of this income

inclusion and includes \$20x in gross income as a deemed dividend under section 78. Accordingly, DT recognizes \$100x (\$80x + \$20x) of gross income because of FS's sale of property to FA.

(ii) Analysis. Pursuant to section 7874(a)(2)(A), DT is an expatriated entity. Under paragraph (b)(1) of this section, DT's \$100x gross income recognized under sections 951(a)(1)(A) and 78 is inversion gain, because it is income recognized by an expatriated entity during the applicable period by reason of an indirect transfer of property by DT (through its wholly-owned CFC, FS) after the inversion transaction to a specified related person (FA). Sections 7874(a)(1) and (e) therefore prevent the use of certain tax attributes (such as net operating losses) to reduce the U.S. tax owed with respect to DT's \$100x gross income recognized under sections 951(a)(1)(A) and 78.

(f) Applicability dates. Except as otherwise provided in this paragraph (f), this section applies to transfers and licenses of property completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (b) of this section by excluding the phrase "(including an amount treated as a dividend under section 78)" for transfers and licenses of property completed on or after November 19, 2015, and before **April 4, 2016**.

(g) Expiration date. This section expires on **April 4, 2019**.

Par. 24. Section 1.7874-12T is added to read as follows:

§1.7874-12T Definitions (temporary).

(a) Definitions. Except as otherwise provided, the following definitions apply for purposes of §§1.367(b)-4T, 1.956-2T, 1.7701(l)-4T, 1.7874-2, 1.7874-2T, and 1.7874-6T through 1.7874-11T.

(1) An affiliated group has the meaning set forth in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears. A member of the affiliated group is an entity included in the affiliated group.



(2) The applicable period means, with respect to an inversion transaction, the period described in section 7874(d)(1). However, see also §1.7874-2T(b)(13) in the case of a subsequent acquisition (or a similar acquisition under the principles of §1.7874-2T(c)(4)(i)) that is an inversion transaction.

(3) The completion date means, with respect to a domestic entity acquisition, the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete.

(4) A controlled foreign corporation (or CFC) has the meaning provided in section 957.

(5) A domestic entity acquisition means an acquisition described in section 7874(a)(2)(B)(i).

(6) A domestic entity means, with respect to a domestic entity acquisition, a domestic corporation or domestic partnership described in section 7874(a)(2)(B)(i). A reference to a domestic entity includes a successor to such domestic corporation or domestic partnership, including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381.

(7) An expanded affiliated group (or EAG) means, with respect to a domestic entity acquisition, an affiliated group that includes the foreign acquiring corporation, determined as of the completion date. A member of the EAG is an entity included in the EAG.

(8) An expatriated entity means, with respect to an inversion transaction--

(i) The domestic entity; and

(ii) A United States person that, on any date on or after the completion date, is or was related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity.

(9) Expatriated foreign subsidiary--(i) General rule. Except as provided in paragraph (a)(9)(ii) of this section, an expatriated foreign subsidiary means a foreign corporation that is a CFC and in which an expatriated entity is a United States shareholder.

(ii) Exception to the general rule. A foreign corporation is not an expatriated foreign subsidiary if, with respect to the inversion transaction as a result of which the foreign corporation otherwise would be an expatriated foreign subsidiary--

(A) On the completion date, the foreign corporation was both a CFC and a member of the EAG; and

(B) On or before the completion date, the domestic entity was not a United States shareholder with respect to the foreign corporation.

(10) A foreign acquiring corporation means, with respect to a domestic entity acquisition, the foreign corporation described in section 7874(a)(2)(B). A reference to a foreign acquiring corporation includes a successor to the foreign acquiring corporation, including a corporation that succeeds to and takes into account amounts with respect to the foreign acquiring corporation pursuant to section 381.

(11) A foreign related person means, with respect to an inversion transaction, a foreign person that is related (within the meaning of section 267(b) or 707(b)(1)) to, or under the same common control as (within the meaning of section 482), a person that is an expatriated entity with respect to the inversion transaction.

(12) A former domestic entity partner of a domestic entity that is a domestic partnership is any person that held an interest in the partnership before the domestic entity acquisition, including any person that holds an interest in the partnership both before and after the domestic entity acquisition.

(13) A former domestic entity shareholder of a domestic entity that is a domestic corporation is any person that held stock in the domestic corporation before the domestic entity acquisition, including any person that holds stock in the domestic corporation both before and after the domestic entity acquisition.

(14) An interest in a partnership includes a capital or profits interest.

(15) An inversion transaction means a domestic entity acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), taking into account section 7874(a)(3).

(16) A non-CFC foreign related person means, with respect to an inversion transaction, a foreign related person that is not an expatriated foreign subsidiary.

(17) The ownership fraction means, with respect to a domestic entity acquisition, the ownership percentage described in section 7874(a)(2)(B)(ii), expressed as a fraction.

(18) A specified related person means, with respect to an inversion transaction--

(i) A non-CFC foreign related person;

(ii) A domestic partnership in which a non-CFC foreign related person is a partner; and

(iii) A domestic trust of which a non-CFC foreign related person is a beneficiary.

(19) A United States person means a person described in section 7701(a)(30).

(20) A United States shareholder has the meaning provided in section 951(b).

(b) Applicability dates. Except as otherwise provided in this paragraph (b), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraph (a)(8) of this section; the phrase “, including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381” in paragraph (a)(6) of this section; and the second sentence of paragraph (a)(10) of this section apply to domestic entity acquisitions completed on or after **April 4, 2016**. For domestic entity acquisitions completed on or after September 22, 2014, and before **April 4, 2016**, however, taxpayers, may elect to apply paragraph (a)(8) of this section; the phrase “, including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381” in paragraph (a)(6) of this section; and the second sentence of paragraph (a)(10) of this section.

(c) Expiration date. This section expires on **April 4, 2019**.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: March 25, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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