HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

Income Tax

Final regulations addressing transactions that are structured to avoid the purposes of sections 7874 and 367 of the Code and certain post-inversion tax avoidance transactions.

Notice 2018–61, page 278.
This notice announces that the Department of the Treasury and the Internal Revenue Service intend to issue regulations providing clarification of the effect of section 67(g), enacted on December 22, 2017, by “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115–97, on the deductibility of certain expenses described in section 67(b) and (e) and §1.67-4 of the Income Tax Regulations that are incurred by estates and non-grantor trusts. These regulations will clarify that estates and non-grantor trusts may continue to deduct each expense that is described in section 67(e)(1) or is allowable under section 642(b), 651 or 661, including the appropriate portion of a bundled fee, in determining the estate or non-grantor trust’s adjusted gross income for all taxable years, even while the application of section 67(a) is suspended pursuant to section 67(g). Additionally, the regulations will clarify that deductions enumerated in section 67(b) and (e) continue to remain outside the definition of “miscellaneous itemized deductions” and thus are unaffected by section 67(g). This notice also requests comments on section 642(h)(2) and §1.642(h)–2(a) in light of new section 67(g).

EXEMPT ORGANIZATIONS

This Revenue Procedure modifies the information to be reported to the IRS by organizations exempt from tax under § 501(a) of the Internal Revenue Code, other than organizations described in § 501(c)(3), that are required to file an annual Form 990 or Form 990–EZ information return. These organizations are no longer required to report the names and addresses of their contributors on the Schedule B of their Forms 990 or 990–EZ. These organizations, however, must continue to collect and keep this information in their books and records and to make it available to the IRS upon request.

Employee Plans

This notice sets forth updates on the corporate bond monthly yield curve, the corresponding spot segment rates for July 2018 used under § 417(e)(3)(D), the 24-month average seg-

Finding Lists begin on page ii.
The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.  
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.  
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.  
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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SUPPLEMENTARY INFORMATION:

Background

I. Overview

On April 8, 2016, the Department of the Treasury (the Treasury Department) and the IRS published final and temporary regulations under sections 304, 367, 956, 7701(l), and 7874 (TD 9761) in the Federal Register (81 FR 20858, as corrected at 81 FR 40810 and 81 FR 46832). On the same date, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–135734–14) in the Federal Register (81 FR 20588, as corrected at 81 FR 35275) by cross-reference to the temporary regulations (the 2016 proposed regulations) (together with the final and temporary regulations described in the preceding sentence, the 2016 regulations). No public hearing was requested or held. Numerous written comments were received with respect to the proposed regulations and are available at www.regulations.gov or upon request. A comment was also received with respect to a notice that preceded the 2016 regulations (Notice 2015–79, 2015–49 I.R.B. 775) and, as explained in the preamble to those regulations, the comment has been included in the administrative record for the proposed regulations. The majority of the comments supported the 2016 regulations.

On January 18, 2017, the Treasury Department and the IRS published final and temporary regulations under section 7874 (TD 9812) in the Federal Register (82 FR 5388, as corrected at 82 FR 42233), which adopted as final regulations the proposed regulations in § 1.7874–4 (including the portions included in the 2016 regulations) and modified certain portions of the 2016 regulations (see 82 FR 5476–01). This Treasury decision adopts the remaining 2016 proposed regulations, with the changes generally described in the Summary of Comments and Explanation of Revisions section of this preamble, as final regulations and removes the corresponding temporary regulations.

II. Section 7874 Background

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, the ownership percentage, and the fraction used to calculate the ownership percentage, 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 when compared to the total business activities of the EAG. 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.” For other definitions used throughout this preamble but not defined in this preamble, see § 1.7874–12 (providing common definitions for purposes of certain regulations under sections 367(b), 956, 7701(l), and 7874).

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 corpora-
tion 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 the domestic entity and certain other persons are subject to special rules that reduce the tax benefits of the inversion transaction. For example, section 7874(a)(1) 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. “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” (the Act), Pub. L. 115–97, amended certain sections of the Code to further reduce the tax benefits of inversion transactions. See section 1(h)(11)(C)(iii) (shareholders of surrogate foreign corporations not eligible for reduced rate on dividends); section 59A (for inverted groups, generally treating costs of goods sold as a base erosion payment for purposes of the base erosion and anti-abuse tax); section 965 (upon certain inversions, recapturing the benefit of a deduction related to a transition tax); and section 4985 (increasing the rate of the excise tax imposed on certain holders of stock options and other stock-based compensation).

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. In addition, 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.

Summary of Comments and Explanation of Revisions

I. Rules Addressing Certain Transactions that Are Structured to Avoid the Purposes of Section 7874

To address certain transactions that are structured to avoid the purposes of section 7874, the 2016 regulations provided 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. The comments and modifications with respect to these rules are discussed in this Part I.

A. Calculation of the ownership percentage

1. Passive assets rule

Section 1.7874–7T of the 2016 regulations provides a rule (the passive assets rule) that excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain passive assets. In general, the rule applies with respect to a domestic entity acquisition if, on the completion date, more than 50 percent of the gross value of all foreign group property constitutes foreign group nonqualified property. The amount of stock that is excluded 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) and stock that is excluded from the denominator of the ownership fraction under either § 1.7874–1(b) or § 1.7874–4(b) (the multiplicand), and (ii) the proportion of foreign group property that is foreign group nonqualified property, determined based on gross value (the foreign group nonqualified property fraction). For purposes of determining the foreign group nonqualified property fraction, property received by the EAG that gives rise to stock excluded from the ownership fraction under § 1.7874–4(b) is not taken into account.

Under the 2016 regulations, the passive assets rule applies for purposes of determining the ownership percentage by vote and value. The Treasury Department and the IRS have determined that applying the rule for purposes of determining the ownership percentage by vote could give rise to administrative complexities, because the rule does not exclude particular shares of stock but instead excludes an amount of stock. In particular, when classes of stock of the foreign acquiring corporation have different voting power, a special rule would be needed to allocate the excluded amount among the shares. Consistent with other rules under section 7874, the Treasury Department and the IRS have concluded that the rule should apply only for purposes of determining the ownership percentage by value. See § 1.7874–8 (excluding an amount of stock for purposes of determining the ownership percentage by value); § 1.7874–10 (treating an amount as additional stock described in section 7874(a)(2)(B)(ii) for purposes of determining the ownership percentage by value). The final regulations therefore contain this modification. See § 1.7874–7(b).

The Treasury Department and the IRS have also determined that the passive assets rule should be modified to take into account the other stock exclusion rules. For example, stock excluded under § 1.7874–8(b) (disregard of certain stock attributable to serial acquisitions) or § 1.7874–9(b) (disregard of certain stock in third-country transactions) should not be taken into account when determining the multiplicand. In addition, property of an entity the acquisition of which gives rise to stock excluded under § 1.7874–8(b) or § 1.7874–9(b) generally should not be taken into account when determining the foreign group nonqualified property fraction. The final regulations thus modify the multiplicand so that stock excluded under any of the stock exclusion rules is not taken into account. See §§ 1.7874–7(b)(1). Further, the final regulations modify the foreign group nonqualified property fraction so that, in general, property that gives rise to stock excluded under any of the stock exclusion rules is not taken into account. See § 1.7874–7(e)(3). The final regulations also include an example illustrating
these rules. See § 1.7874–7(f) Example 4.

Further, in response to a comment, the final regulations clarify that the passive assets rule is subject to section 7874(c)(4). See § 1.7874–7(a) (penultimate sentence). For example, section 7874(c)(4) can apply to the transfer of properties or liabilities as part of a plan a principal purpose of which is to prevent the more-than-50-percent threshold of the passive assets rule from being satisfied with respect to a domestic entity acquisition. In these cases, section 7874(c)(4) would disregard the transaction and, as a result, the passive assets rule (including the more-than-50-percent threshold) would be applied as if the transfer did not occur.

Lastly, and also in response to a comment, the Treasury Department and the IRS clarify § 1.7874–7(e)(1)(i)(C), which excludes property that gives rise to income described in section 1297(b)(2)(A) or (B) from the definition of foreign group nonqualified property. Under section 1297(b)(2)(A) and (B), for certain purposes of the passive foreign investment company rules, passive income does not include certain income derived in the active conduct of a banking or insurance business. The final regulations clarify that for purposes of determining whether property qualifies for the exclusion under § 1.7874–7(e)(1)(i)(C), other passive foreign investment company rules do not apply. See § 1.7874–7(e)(1)(i)(C) (parenthetical language). Thus, for example, the rules in section 1298(b)(2) or (3) that except certain corporations from being treated as passive foreign investment companies during a start-up year or following a change in business do not apply for this purpose.

2. Serial Acquisitions of Domestic Entities

Section 1.7874–8T of the 2016 regulations provides a rule (the serial acquisition rule) that, with respect to a domestic entity acquisition (a relevant domestic entity acquisition), excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain domestic entity acquisitions previously completed by the foreign acquiring corporation (or a predecessor).

Consistent with the explanation in the preamble to the 2016 regulations, this rule addresses a concern that domestic entity acquisitions previously completed by the foreign acquiring corporation serve as a platform for additional and even larger domestic entity acquisitions.

For administrability purposes, the serial acquisition rule under the 2016 regulations looks only to whether the foreign acquiring corporation completed a domestic entity acquisition within the 36-month period ending on the signing date of the relevant domestic entity acquisition (such acquisition, in general, a “prior domestic entity acquisition”). Absent this 36-month look-back period, the rule could be difficult to administer, as all domestic entity acquisitions previously completed by the foreign acquiring corporation would need to be identified. In addition, as the period between a relevant domestic entity acquisition and a previous domestic entity acquisition increases, it may become more difficult to determine which stock of the foreign acquiring corporation is attributable to the previous domestic entity acquisition (for example, due to changes in the capital structure of the foreign acquiring corporation resulting from divisive or acquisitive transactions). The use of a 36-month look-back period provides an administrable standard and is consistent with other look-back periods under the Code and regulations. See, e.g., section 865(f) (sourcing rule for sales of stock in a foreign affiliate); section 2035 (transfers before death); section 7701(b)(3) (substantial presence test for residency); and § 1.7874–10 (NOCD rule). The final regulations therefore retain the 36-month look-back period.

The majority of the comments received on the 2016 regulations involved the serial acquisition rule. Of those comments, nearly every one supported the rule.

One comment, however, while generally supporting the prevention of inversions, asserted that the serial acquisition rule targets a specific transaction that was pending when the 2016 regulations were issued. The comment suggested that this would cause mistrust of federal agencies and could ultimately harm U.S. businesses. The Treasury Department and the IRS disagree with the comment. The serial acquisition rule does not target a specific transaction. Instead, and as explained in the preamble to the 2016 regulations, it addresses a particular practice occurring in the marketplace in which a foreign acquiring corporation completes multiple domestic entity acquisitions over a span of just a few years, with the corporation’s increased value serving as a platform to complete still larger domestic entity acquisitions that avoid the application of section 7874. The Treasury Department and the IRS have concluded that such serial acquisitions, which in effect permit a single foreign acquiring corporation to facilitate the inversion of multiple domestic entities over time, are inconsistent with the policies underlying section 7874. As also explained in the preamble to the 2016 regulations, the Treasury Department and the IRS have determined that the rule appropriately addresses this practice. See Part I.B.3.a of the Explanation of Provisions of the preamble to the 2016 regulations; see also S. Rep. No. 192, at 142 (2003) (expressing concern that certain inversions “perimit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations.”).

One other comment asserted that the serial acquisition rule exceeds statutory authority and lacks a reasoned explanation. Those same claims were subsequently asserted in Chamber of Commerce of the United States v. Internal Revenue Serv., No. 1:16–CV–944–LY (W.D. Tex. Sept. 29, 2017), appeal docketed, No. 17–51063 (5th Cir. Dec. 1, 2017), in which the serial acquisition rule in the temporary regulations was challenged. While the district court invalidated the temporary regulation on procedural grounds because it was not subjected to prior notice and comment, the court found that the serial acquisition rule was substantively valid under sections 7874(c)(6) and (g) (the Code sections under which the Treasury Department and the IRS promulgated the rule). The court concluded that the rule did not exceed the statutory authority of the Treasury Department and the IRS because it was within their broad authority under section 7874 to “treat stock as not stock”—the exercise of which, the
Third, the final regulations define a predecessor of a foreign acquiring corporation for purposes of the serial acquisition rule. See § 1.7874–8(b) (defining predecessor by cross-reference to the definition in the NOCD rule under § 1.7874–10(f)(1)).

3. Third-Country Rule

Section 1.7874–9T of the 2016 regulations provides a rule (the third-country rule) that excludes stock of the foreign acquiring corporation from the denominator of the ownership fraction when a domestic entity acquisition is a “third-country transaction,” which occurs when three requirements are satisfied. First, the foreign acquiring corporation must complete a “covered foreign acquisition” in a transaction related to the domestic entity acquisition. In general, a covered foreign acquisition is an acquisition by the foreign acquiring corporation of another foreign corporation (such acquisition, a “foreign acquisition,” and such corporation, an “acquired foreign corporation”), provided that an ownership continuity requirement is satisfied. Second, after all related transactions are complete, the foreign acquiring corporation must be a tax resident in a “third country” — that is, a foreign country other than the foreign country in which, before the foreign acquisition and any related transaction, the acquired foreign corporation was a tax resident. (The 2016 regulations refer to the country in which a corporation is “subject to tax as a resident,” rather than the country in which a corporation is “tax resident.”) However, similar to the reasons discussed in Part I.C. of this Summary of Comments and Explanation of Revisions section (concerning the substantial business activities test), the final regulations refer to “tax resident.” And third, the ownership percentage, determined without regard to the third country rule, must be at least 60 (by vote or value).

As explained in Notice 2015–79, the Treasury Department and the IRS have determined that when a domestic entity acquisition is a third-country transaction, the decision to locate the tax residence of the foreign acquiring corporation in the third country generally is driven by tax planning, including the facilitation of U.S. tax avoidance following the acquisition, and, as a result, generally is contrary to the policies underlying section 7874. Accordingly, the third country rule provides that 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 is excluded from the denominator of the ownership fraction.

a. Exceptions to rule’s application

A comment suggested that the Treasury Department and the IRS consider adding one or more exceptions to the third-country rule, so as to better tailor the rule’s application to domestic entity acquisitions in which the use of a third country is likely driven by tax planning. The comment recommended against an exception based on the subjective criterion of whether a non-tax business purpose exists for the foreign acquiring corporation’s use of the third country. Instead, the comment suggested that any exception should be based on objective criteria. In particular, the comment proposed exceptions based on (i) the foreign group’s business activities in the third country, and (ii) a comparison of the treaty benefits (specifically, the withholding tax rate with respect to dividends, interest, and royalties) available to the foreign acquiring corporation in the third country as compared to the benefits that would be available in the country in which the acquired foreign corporation is a tax resident.

In response to the comment, the final regulations provide that the third-country rule generally does not apply if the EAG has substantial business activities in the third country compared to the total business activities of the EAG. See § 1.7874–9(d)(4)(ii) (providing an exception to the definition of a covered foreign acquisition). For this purpose, the principles of § 1.7874–3 apply, and the determination of whether there are substantial business activities is made without regard to the domestic entity acquisition.

The final regulations also generally provide that the third-country rule does not apply if (i) both the foreign acquiring corporation and the acquired foreign corporation are created or organized in, or under the law of, a foreign country that

court noted, could in certain cases “substantially alter a calculation under the statute”—and to prevent the avoidance of the purposes of section 7874. The court also “reviewed the full analysis by which the Agencies determined the Rule is necessary” and concluded that the Treasury Department and the IRS provided a sufficient explanation in issuing the serial acquisition rule in the temporary regulation, and did not engage in arbitrary and capricious rulemaking.

The final regulations adopt the rule with three technical clarifications or modifications, in response to comments.

First, the final regulations clarify that the determination of stock of the foreign acquiring corporation attributable to a prior domestic entity acquisition does not take into account stock of the foreign acquiring corporation deemed under § 1.7874–10(b) (the NOCD rule) or section 7874(c)(4) more broadly to have been received in the prior domestic entity acquisition. See § 1.7874–8(g)(3) (excluding such stock from the definition of total number of prior acquisition shares).

Second, the final regulations provide an exception to the definition of the term prior domestic entity acquisition in addition to the one under the 2016 regulations (relating to certain de minimis acquisitions). Under this additional exception, the term does not include a domestic entity acquisition that occurs within a foreign-parented group and qualifies for the internal group restructuring exception of § 1.7874–1(c)(2). See § 1.7874–8(g)(4)(ii)(B). In these cases, the Treasury Department and the IRS have determined that because the domestic entity remains (or is considered to remain) within the same foreign-parented group, the acquisition should not be viewed as creating a platform to complete larger domestic entity acquisitions. As a result, the Treasury Department and the IRS have concluded that these acquisitions do not give rise to the policy concerns underlying the serial acquisition rule. Accordingly, like under the 2016 regulations, the term prior domestic entity acquisition under the final regulations means any domestic entity acquisition completed by the foreign acquiring corporation (or a predecessor) within a 36-month look-back period, except for those acquisitions that, for administrative or policy reasons, qualify for an exception.
The Treasury Department and the IRS have determined that the migration from one no-income-tax jurisdiction to another such jurisdiction is unlikely to be driven by tax planning, as the countries would generally be equally favorable from a tax perspective.

The Treasury Department and the IRS decline, however, to provide an additional exception based on a comparison of treaty benefits. Even if the withholding rates with respect to certain categories of income are at least as high under the U.S. tax treaty with the third country as compared to the U.S. tax treaty with the country in which the acquired foreign corporation is a tax resident, the use of the third country may nevertheless be motivated by tax planning. For example, there could be tax-related features other than withholding rates that make the third country more advantageous; and, significant administrative difficulties could arise if the comparison were to include those features. Moreover, the third country might have a less restrictive regime for controlled foreign corporations, which could facilitate the use of low- or no-taxed entities to erode the U.S. tax base following the domestic entity acquisition. Consistent with the explanation in Notice 2015–79, the Treasury Department and the IRS have concluded that it is appropriate for the third-country rule to address this concern.

4. NOCD Rule

Section 1.7874–10T of the 2016 regulations provides a rule (the NOCD rule) that, for purposes of determining the ownership percentage by value, deems former domestic entity shareholders or former domestic entity partners 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 (such stock, “NOCD stock”). The rule provides mechanics for determining NOCDs.

The final regulations include seven clarifications or modifications to the NOCD rule, in response to comments. First, the regulations clarify and refine the definition of distribution. The 2016 regulations define the term broadly but provide several exclusions, including, in general, an exclusion for a distribution that occurs pursuant to an asset reorganization. The final regulations clarify that the exclusion does not apply to a distribution to which section 355 applies, regardless of whether in connection with a reorganization described in section 368(a)(1)(D). See § 1.7874–10(k)(1)(i)(C). That is, a distribution of stock of a controlled corporation pursuant to a divisive reorganization is a distribution for purposes of the NOCD rule, but a distribution of an acquiring corporation’s stock pursuant to an acquisitive reorganization (such as a merger described in section 368(a)(1)(A)) is not a distribution for this purpose. In addition, the final regulations refine the definition of distribution such that, in the case of a partnership, a distribution does not include a deemed distribution pursuant to section 752(b) to the extent that the transaction giving rise to the deemed distribution does not reduce the partnership’s value.

Second, the final regulations modify a special rule that applies when a domestic corporation (distributing corporation) distributes 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 controlled corporation represents more than 50 percent of the fair market value of the stock of the 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 final regulations modify the condition for the rule to apply: as modified, the rule considers the fair market value of the stock of the controlled corporation owned by the distributing corporation and any related person. See § 1.7874–10(g). Accordingly, the special rule would not apply, for example, if the fair market value of the stock of the distributing corporation were $100x (not taking into account the fair market value of the stock of the controlled corporation), the fair market value of the stock of the controlled corporation were $110x, and $100x or less of the stock of the controlled corporation were owned by the distributing corporation (with the balance owned by a person unrelated to the distributing corporation).

Third, the final regulations clarify how the NOCD rule relates to the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1 (the EAG rules). The preamble to the 2016 regulations indicates that the NOCD rule applies only for purposes of determining the ownership percentage by value and that it does not apply for any other purpose, including the loss of control exception of § 1.7874–1(c)(3) (one of the EAG rules). The final regulations clarify that NOCD stock is not taken into account for purposes of the EAG rules. See § 1.7874–1(d)(2) (providing that NOCD stock is not taken into account for purposes of determining the members of an EAG or whether a domestic entity acquisition qualifies for the internal
group restructuring or loss of control exception). As a result, the determination of the EAG and whether a domestic entity acquisition qualifies for the internal group restructuring or loss of control exception is based on the stock of the foreign acquiring corporation that actually exists. See also Part I.B of this Summary of Comments and Explanation of Revisions section (discussing the interaction of the stock exclusion rules and the EAG rules).

Fourth, the final regulations provide guidance regarding how to allocate NOCD stock among the former domestic entity shareholders. Because the NOCD rule provides that NOCD stock is treated as stock described in section 7874(a)(2)(B)(ii), in most cases the NOCD stock will simply be included in both the numerator and denominator of the ownership fraction and, as a result, it will be irrelevant which former domestic entity shareholders or former domestic entity partners are considered to hold such stock. However, in certain cases involving the application of the EAG rules, the allocation of the NOCD stock among the former domestic entity shareholders or former domestic entity partners may affect whether the stock is included in the numerator and denominator of the ownership fraction.

For example, assume two foreign corporations, F1 and F2, each own 50% of the stock of a domestic corporation, DT. During year y, DT makes a $10x distribution to each of F1 and F2 and, thereafter, distributes $40x to F2 in redemption of all of F2’s stock of DT. Then, on December 31 of year y, and in a transaction related to the redemption, F1 contributes all of the stock of DT to a newly-formed foreign corporation, FA, in exchange for all of the stock of FA (DT acquisition). Assume that there are $36x of NOCDs with respect to the look-back year ending on December 31 of year y and that there are no NOCDs with respect to the other look-back years. An EAG exists (for this purpose, NOCD stock is not taken into account), composed of F1, FA, and DT, but the DT acquisition does not qualify for the internal group restructuring exception because F1 did not own 80 percent or more of the stock of DT before the DT acquisition and any related transaction. See § 1.7874–1(c)(2)(i) and (g). Moreover, the acquisition does not qualify for the loss of control exception because after the acquisition F1 (a former domestic entity shareholder) holds more than 50 percent of the stock of a member of the EAG. See § 1.7874–1(c)(3). Thus, all FA stock held by F1, including any NOCD stock considered held by F1, is excluded from the numerator and denominator of the ownership fraction. See § 1.7874–1(b). Any NOCD stock considered held by F2, however, is included in both the numerator and the denominator of the ownership fraction.

To address this allocation issue, the final regulations provide that NOCD stock is allocated among the former domestic entity shareholders or former domestic entity partners based on the amount of NOCDs that the persons are treated as receiving. See § 1.7874–10(h). For this purpose, and for ease of administration, the regulations provide that a pro rata portion of each distribution during a look-back year is treated as comprising an NOCD with respect to the look-back year, based on the amount of NOCDs during the year relative to the total amount of distributions during the year. Thus, in the example above, because 60 percent of the distributions during year y constituted NOCDs ($36x/$60x), 60 percent of each of the $10x dividend distributions to F1 and F2, as well as 60 percent of the $40x distribution to F2 as part of the redemption, are treated as comprising the NOCD. Accordingly, under § 1.7874–10(h), F1 and F2 are treated as having received $6x and $30x of distributions comprising the NOCD, respectively. F1 and F2 are therefore treated as holding $6x and $30x of NOCD stock, respectively. As a result, the ownership percentage (by value) with respect to the DT acquisition is 100 ($30x/ $30x).

Fifth, the final regulations provide guidance when multiple foreign acquiring corporations complete a domestic entity acquisition, as to which corporation’s or corporations’ stock the NOCD stock is considered comprised. In general, the final regulations provide that the NOCD stock is considered comprised, on a pro rata basis, of stock of each foreign acquiring corporation that directly or indirectly provided consideration in the domestic entity acquisition. For this purpose, consideration is not considered directly provided by a foreign acquiring corporation if it was indirectly provided by another foreign acquiring corporation. See § 1.7874–10(i). For example, assume FP, a foreign corporation, owns all the stock of FS, also a foreign corporation, and FS acquires all the stock of DT, a domestic corporation, solely in exchange for FP stock. Pursuant to § 1.7874–2(c)(1)(i) and (iii), both FS and FP are treated as having completed a domestic entity acquisition. Under § 1.7874–10(i), because FP indirectly provided 100 percent of the consideration in the domestic entity acquisition, stock of FP is considered to comprise 100 percent of any NOCD stock.

Sixth, the final regulations address how the NOCD rule applies when, pursuant to § 1.7874–2(e), two or more domestic entities are treated as a single domestic entity. Specifically, the regulations provide that the NOCD rule is initially applied to each domestic entity on a separate basis, and then the amount of NOCDs treated as made by the single domestic entity is the sum of the separately computed NOCDs made by each domestic entity. See § 1.7874–10(j).

Finally, the final regulations confirm that NOCD stock is included in both the numerator and the denominator of the ownership fraction, except to the extent that the stock is treated as held by a member of the EAG and excluded from the numerator or both the numerator and denominator, as applicable, under the EAG rules. See § 1.7874–1(d)(2).

5. De Minimis Exceptions

Certain stock exclusion rules under section 7874 contain a de minimis exception. See § 1.7874–4(b) (disqualified stock rule); § 1.7874–7T(b) (passive assets rule); and 1.7874–10T(b) (NOCD rule). As explained in the preamble to TD 9812 (final regulations regarding the disqualified stock rule), together the de minimis exceptions generally prevent one or more of the disqualified stock rule, the passive assets rule, and NOCD rule from causing section 7874 to apply to a domestic entity acquisition that, given minimal actual ownership continuity, largely resembles a cash purchase by the foreign acquiring corporation of the stock of (or interests in) the domestic entity.
Each of the de minimis exceptions is satisfied when two requirements are met. First, the ownership percentage—determined without regard to the application of the disqualified stock rule, the passive asset rules, and the NOCD rule—must be less than five percent (by vote and value). Second, after the domestic entity acquisition and all related transactions, each former domestic entity shareholder or former domestic entity partner, as applicable, 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) the foreign acquiring corporation for purposes of determining the ownership fraction, with respect to the disqualified stock rule and the passive asset rules. The final regulations generally disregard stock of the foreign acquiring corporation for purposes of determining the ownership fraction—namely, the serial acquisition rule and the third-country rule, as well as section 7874(c)(4) generally, the application of which in certain cases would similarly disregard stock of the foreign acquiring corporation. The final regulations provide a general coordination rule in § 1.7874–1T(d)(1) to coordinate the stock exclusion rules and the EAG rules, and remove provisions of the existing regulations that are duplicative of this rule. See § 1.7874–4T(i), Example 8 and Example 9 for illustrations involving the general coordination rule.

C. The substantial business activities test

Section 1.7874–3T(b)(4) of the 2016 regulations provides that, for an EAG to be considered to have substantial business activities in the relevant foreign country, the foreign acquiring corporation must be subject to tax as a resident of the “relevant foreign country” (the tax residence requirement). The relevant foreign country means the foreign country in which, or under the law of which, the foreign acquiring corporation was created or organized (country of organization). The tax residence requirement is in addition to the three qualitative requirements relating to the percentage of employees, assets, and income in the relevant foreign country. See § 1.7874–3(b)(1) through (3).

One comment made several recommendations with respect to the substantial business activities test. First, the comment recommended providing standards for determining when the tax residence requirement is considered satisfied, including in cases in which the relevant foreign country is a no-income-tax jurisdiction. The comment suggested that the standards be based on the definition of residence under the United States’ income tax treaties with foreign countries. It further suggested providing guidance on when a foreign acquiring corporation is considered to be fiscally-transparent in, and thus not a tax resident of, the relevant foreign country.

The Treasury Department and the IRS generally agree with these recommendations. The final regulations thus define a tax resident of a country as a body corporate liable to tax under the laws of the country as a resident. See § 1.7874–3(d)(11). The Treasury Department and the IRS have concluded that defining tax resident in this manner obviates the need to provide specific guidance on when a foreign acquiring corporation is treated as fiscally-transparent under the laws of the relevant foreign country. In addition, the Treasury Department and the IRS have determined that when the relevant foreign country is a country that does not impose corporate income tax, the tax residency requirement should not apply. See § 1.7874–3(b)(4) (second sentence).

The comment also suggested that the Treasury Department and the IRS consider changing the definition of relevant foreign country from the country of organization to the country in which the foreign acquiring corporation is a tax resident. Under this approach, the substantial business activities test would look to the percentage of the EAG’s employees, assets, and income in the foreign country where the foreign acquiring corporation is a tax resident, without regard to the corporation’s country of organization. The Treasury Department and the IRS have concluded that section 7874(a)(2)(B)(iii) requires substantial business activities in the country of organization, with tax residency in that country serving as a neces-
sary component for establishing substantial business activities. Accordingly, the final regulations do not adopt this comment.

II. Rules Addressing Certain Post-Inversion Tax Avoidance Transactions

As described in the preamble to the 2016 regulations, as well as in Notice 2015–79 and Notice 2014–52 (2014–42 I.R.B. 712), 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. To reduce the tax benefits of certain post-inversion tax avoidance transactions, the 2016 regulations provided rules under sections 304(b)(5)(B), 367, 956(e), 7701(l), and 7874. The comments and modifications with respect to these rules are discussed in this Part II.

A. United States property rule

Section 1.956–2T(a)(4)(i) of the 2016 regulations 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 (i) the obligation or stock is held by a CFC that is an expatriated foreign subsidiary (EFS), (ii) the foreign person or foreign corporation is a non-CFC foreign related person, and (iii) the obligation or stock was acquired either before 2011. For clarity, the final regulations use the term “non-EFS foreign related person” instead of the term “non-CFC foreign related person.”

In addition, the final regulations modify various examples involving foreign corporations that were not controlled foreign corporations before the effective date of section 14214 of the Act (amending section 958(b) so as to provide “downward attribution” of stock from foreign persons to United States persons). In general, the final regulations now refer to those foreign corporations as CFCs, as appropriate, and otherwise retain the regulations under sections 367(b), 956, and 7701(l). Although the recent amendment to section 958(b)(4) makes it more difficult for post-inversion planning to cause an EFS to cease to be a CFC, such planning could still substantially dilute a United States shareholder’s interest in the EFS. Accordingly, the recharacterization rules under § 1.7701(l)–4T concerning post-inversion dilution are finalized. The Treasury Department and the IRS decline at this time to extend the application of § 1.7701(l)–4 to all foreign-parented groups, in part, because other provisions may address such planning, including the fast-pay arrangement rules under § 1.7701(l)–3.

Further, for purposes of determining whether an entity is an EFS, the final regulations provide that downward attribution from a non-United States person to a United States person does not apply. Absent this modification, in certain cases the term EFS would be over-inclusive and, as a result, the term non-EFS foreign related person would be under-inclusive; this could result in the regulations under sections 367(b), 956, and 7701(l) inappropriately not applying in certain cases. Similarly, the final regulations provide that, when determining if an entity is a CFC for purposes of § 1.304–7, downward attribution from a non-United States person to a United States person does not apply. The Treasury Department and the IRS have determined that these modifications—the effect of which is that the determination of whether an entity is an EFS, as well as whether an entity is a CFC for purposes of § 1.304–7, is the same under pre- and post-Act law—are necessary to carry out the purposes of the provisions.

III. Miscellaneous Rules

A. New definitions section in section 7874 regulations

Section 1.7874–12T of the 2016 regulations provides definitions for certain terms commonly used in §§ 1.367(b)–4, 1.956–2, 1.7701(l)–4, and certain of the section 7874 regulations. These final regulations adopt this definitions section. They also update other portions of the section 7874 regulations to conform those sections with the nomenclature used in § 1.7874–12.

B. Rules under section 956 relating to the definition of obligation


C. Applicability dates

Section 7805(b)(1)(B) and (C) provide that a final regulation may apply to a taxable period ending on or after the date on which a proposed or temporary regulation to which the final regulation relates was filed with the Federal Register or the date on which a notice substantially describing the expected contents of the regulation was issued to the public. The applicability dates of the rules in the final regulations are generally the same as the applicability dates of the rules as set forth in the 2016 regulations, which were issued as temporary regulations to address transactions that are structured to avoid the
purposes of sections 7874 and 367 and certain post-inversion tax avoidance transactions. Accordingly, the applicability date of some provisions in the final regulations corresponds to the date the 2016 regulations were filed with the Federal Register, and the applicability dates of other provisions in the final regulations predate the filing of the 2016 regulations and correspond to the issuance of Notice 2014–52, 2014–42 I.R.B. 712, which was issued on September 22, 2014, or Notice 2015–79, 2015–49 I.R.B. 775, which was issued on November 19, 2015.

However, differences between the final regulations and the 2016 regulations generally apply on a prospective basis, with an option for taxpayers to apply the differences retroactively. Moreover, because taxpayers may have relied on the 2016 regulations, the modifications to the final regulations generally apply prospectively. However, domestic entity acquisitions completed before July 12, 2018 continue to be subject to those rules as set forth in the 2016 regulations (but generally with an option for taxpayers to apply the differences retroactively).

Statement of Availability of IRS Documents


Special Analyses

Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This rule has been designated a “significant regulatory action” although not economically significant, under section 3(f) of Executive Order 12866. Accordingly, the rule has been reviewed by the Office of Management and Budget. This final rule is considered an EO 13771 deregulatory action. For more detail on the economic analysis, please refer to the analysis below.

Need for the Final Regulations

These final regulations refine and clarify certain aspects of the proposed and temporary regulations published in 2016 (collectively referred to as the 2016 regulations, as explained in the preamble). The changes finalized in this set of regulations help to ensure that the regulations do not impact mergers that provide market benefits independent of tax avoidance; for example, those that increase efficiencies within the corporation or provide other growth opportunities that contribute to social welfare. These regulations still maintain the thresholds and substantiation requirements of the 2016 regulations aimed at discouraging tax-motivated inversions.

Background

Cross-border mergers can make the U.S. economy stronger by enabling U.S. companies to invest overseas and encouraging foreign investment to flow into the United States. In order for these benefits to be realized, these transactions should be driven by underlying economic considerations rather than by a desire to avoid U.S. taxes. One way for a U.S.-based multinational to avoid or reduce U.S. tax is for the company to expatriate by changing its tax residence from the U.S. to another country through an inversion transaction. Though there are some limitations, the transaction allows the inverted company to reduce future taxes on U.S.-source earnings, for example, by deducting interest paid on loans from the new foreign parent. In addition to potentially eroding the U.S. tax base, inversions may impose other costs on the U.S. economy. For instance, as a result of the inversion, a company’s headquarters may move overseas. This loss of a U.S. corporate identity or location of headquarters for the company may reduce employment in the United States.

To limit inversions that are tax-motivated, section 7874 (enacted in 2004), in general, targets transactions in which a foreign corporation acquires a domestic corporation and, immediately after the transaction, the former shareholders of the domestic corporation make up a significant portion of the shareholders of the acquiring foreign corporation. If the former shareholders of the domestic corporation hold 80 percent or more of the stock of the foreign corporation after the transaction, the foreign corporation is treated as a domestic corporation for U.S. tax purposes. If the former shareholders hold at least 60 percent but less than 80 percent of the stock of the foreign acquiring corporation after the transaction, the transaction is respected but use of tax attributes such as net operating losses and foreign tax credits is limited. Transactions where the former shareholders of the domestic corporation hold less than 60 percent of the stock of the foreign acquiring corporation are generally not limited.

Since the enactment of section 7874, multiple sets of regulations have been issued interpreting the statute and restricting the ability of domestic corporations to undertake an inversion transaction.

The Tax Cuts and Jobs Act of 2017 (TCJA) reduced, but did not completely eliminate, the tax-motivated incentives to invert. Particular TCJA provisions that reduced those incentives include the reduction in the maximum U.S. statutory corporate tax rate from 35 percent to 21 percent, the exemption from U.S. tax of dividends received from certain foreign corporations, the strengthening of Internal Revenue Code Section 163(j) on interest stripping, and the adoption of four punitive disincentives for new inversions in the 60 percent to 80 percent range. While the TCJA also included provisions that may increase incentives to invert, including the tax imposed on Global Intangible Low Tax Income (GILTI) of foreign subsidiaries, overall tax-motivated incentives to invert were reduced.

The following qualitative analysis provides further detail regarding the anticipated impacts of this rulemaking.
Baseline

The 2016 regulations serve as the no-action baseline for our tax regulatory review. The 2016 regulations, which were issued pursuant to authority under sections 7874 and 7805 (as well as other sections), restrict the ability of U.S. companies to invert and reduce the incentives to invert.

Alternatives

As an alternative to these final regulations, Treasury considered retaining the 2016 regulations without amendment. Given public comment and the agency’s desire to provide transparency and clarity to the public, Treasury decided against this approach and moved forward with the final regulations as drafted.

Anticipated Impacts

These final regulations maintain the thresholds and substantiation requirements of the 2016 regulations aimed at discouraging tax-motivated inversions. In response to public comments, the final regulations make certain limited changes to the 2016 regulations that are designed to improve clarity, provide additional exceptions to their application, and reduce unnecessary burdens on taxpayers, including by providing guidance on how to apply particular mechanical rules. Specifically, clarifying changes were made to certain of the stock exclusion rules, and in particular, the passive assets rule, the serial acquisition rule, and the third country rule, as well as to the substantial business activities rule. Additional exceptions were added to the serial acquisition rule and the third country rule that narrowed their scope on the margins. Finally, changes to the passive assets rule, the NOCD rule, and the rules coordinating the application of the stock exclusion rules with the expanded affiliated group (EAG) rules were made to reduce complexity and ambiguity associated with these provisions.

Given the limited nature of the changes made by these final regulations relative to the no-action baseline, Treasury estimates that collectively, these final regulations are not economically significant under Executive Order 12866.

Revenue impacts

Due to the narrow scope of clarifications and refinements in the final regulations and the small number of taxpayers subject to these regulations, Treasury does not anticipate any meaningful change to revenues.

Anticipated benefits

At the margin, the final regulations may increase the incentive for cross-border mergers that are economically beneficial and not tax-motivated. The regulations are designed to help ensure that the regulations do not impact mergers that provide market benefits. Economically beneficial mergers make the U.S. economy stronger by enabling U.S. companies to invest overseas and encouraging foreign investment to flow into the U.S.

Anticipated costs

The changes made by the final regulations are designed generally to reduce unnecessary burdens on taxpayers, an action that may lead to increased merger activity, and some of these additional mergers may potentially be tax-motivated at least in part. Due to the narrow scope of these changes, however, Treasury anticipates that any increase in tax-motivated cross-border merger activity will be relatively small relative to the no-action baseline and will not result in any meaningful adverse effects on economic activity relative to the no-action baseline. In particular, additional exceptions added to the serial acquisition rule and the third country rule are designed to narrow their role in defining cross-border mergers that are subject to targeted tax treatment.

Effects on compliance costs

The final regulations narrow the scope of regulated activities and reduce compliance costs relative to the 2016 regulations. The regulations also aim to reduce required paperwork burden, complexity, and ambiguities that may unintentionally discourage legitimate merger activity. In particular, changes that reduce complexity and ambiguity were made to the passive assets rule, the NOCD rule, and the rules coordinating the application of the stock exclusion rules with the expanded affiliated group (EAG) rules. Clarifying changes were made to the passive assets rule, the serial acquisition rule, the third country rule, and the substantial business activities rule.

Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply because the regulations do not impose a collection of information on small entities. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received.

Drafting Information

The principal authors of these regulations are Rose E. Jenkins 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 record-keeping requirements.

Adoption of the 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 removing the entries for §§ 1.304–7T, 1.367(b)–4T, 1.956–2T, 1.7701(l)–4T, 1.7874–2T, 1.7874–3T, 1.7874–6T, 1.7874–7T, 1.7874–8T, 1.7874–9T, 1.7874–10T, 1.7874–11T, 1.7874–12T and adding entries for §§ 1.304–7, 1.7701(l)–4, 1.7874–2, 1.7874–6, 1.7874–7, 1.7874–8, 1.7874–9, 1.7874–10, 1.7874–11, and 1.7874–12 in numerical order and revising the entry for § 1.367(b)–4 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
§ 1.304–7 Certain acquisitions by foreign acquiring corporations.

(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 rules for determining which earnings and profits are taken into account for purposes of applying section 304(b)(5)(B) (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.

(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 includable in the earnings and profits of a controlled foreign corporation (include by a controlled foreign corporation). For purposes of this section, a controlled foreign corporation has the meaning provided in section 957 and without regard to section 953(c), determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person owning stock which is owned by a person who is not a United States person.

(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 I—(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). 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, which is treated as a distribution to which section 301 applies pursuant to 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.

§ 1.304–7T [Removed]

Par. 3. Section 1.304–7T is removed.
Par. 4. Section 1.367(a)(3) is amended by revising paragraphs (c)(3)(iii)(C) and (c)(11)(ii) to read as follows:

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

(c) * * *
(3) * * *
(iii) * * *

(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. tar-
get company. To calculate the aggregate value of NOCDs, the principles of § 1.7874–10, including the rule regarding predecessors in § 1.7874–10(e) and the rule regarding a deemed distribution of stock in certain cases in § 1.7874–10(g), apply. However, this paragraph (c)(3)(iii)(C) does not apply if the principles of the de minimis exception in § 1.7874–10(d) are satisfied.

§ 1.367(a)–3T [Removed]

Par. 5. Section 1.367(a)–3T is removed.

Par. 6. Section 1.367(b)–4 is amended by revising paragraph (a), paragraph (b) introductory text, and paragraphs (b)(1)(i)(C), (d)(1), (e), (f), (g), and (h) to read as follows:

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

(a) Scope. This section applies to 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 for certain paragraphs of this section. 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.

(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 paragraph (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.

(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 foreign subsidiary described in paragraph (b)(1)(i)(A)(1) of this section or an expatriated foreign subsidiary described in paragraph (b)(1)(i)(A)(2) of this section;

(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 controlled foreign corporation for its taxable year beginning January 1, 2017, but not for prior taxable years, except as a result of a transaction described in the facts of an example. 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-EFS foreign related person. All entities have a calendar year tax year for U.S. tax purposes. 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)(ii) 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 paragraph (b)(1)(ii)(A)(2) of this section. 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-EFS foreign related persons—(i) Facts. The facts are the same as in the introductory sentences 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-EFS 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 FT1 stock immediately before the exchange, none of those shares are treated as indirectly owned by FP (a non-EFS foreign related person) for purposes of calculating the pre-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-EFS 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-EFS 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 controlled foreign corporation for its taxable year beginning January 1, 2017, but not for prior taxable years, except as a result of a transaction described in the facts of an example. 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-EFS foreign related person. All entities have a calendar year tax year for U.S. tax purposes. 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 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. The requirement set forth in paragraph (f)(2)(ii) of this section is satisfied because FS is a controlled foreign corporation immediately after the transfer. 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-EFS foreign related person) for purposes of calculating the pre-exchange ownership percentage with respect to FT. 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-EFS 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 FT, FP is treated as directly or indirectly owning 0 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-EFS 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 is 90 (calculated as 100 percent less 10 percent, the percentage of FS stock that non-EFS 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 1.7874–12, the following definitions and special rules apply for purposes of this section.

(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-EFS 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-EFS 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 an exchange, is owned, in the aggregate, directly or indirectly by non-EFS 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 trian-
gular 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, this section applies 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), paragraphs (a), (b) introductory text, (b)(1)(i)(C), (d)(1), (e), (f), and (g) of this section apply 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 on 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.

§ 1.367(b)–4T [Removed]

Par. 7. Section 1.367(b)–4T is removed.

§ 1.367(b)–6 [Amended]

Par. 8. Section 1.367(b)–6 is amended by:
1. Removing paragraph (a)(1)(iii).
2. Redesignating paragraphs (a)(1)(iv) and (v) as (a)(1)(iii) and (iv), respectively.
3. In newly redesignated paragraph (a)(1)(iv), removing the language “1.367(b)–4(a), §” in the first sentence and removing the language “§ 1.367(b)–4(a)” in the second sentence.

Par. 9. Section 1.956–2 is amended by:
1. Revising paragraphs (a)(4), (c)(5), and (d)(2).
2. Adding paragraphs (f) and (h)(3) through (6).
3. Removing paragraph (i).

The revisions and additions read as follows:

§ 1.956–2 Definition of United States property.

(a) * * *

(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 paragraph (a) of this section, United States property does not include—
(A) Any obligation of a non-EFS 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-EFS foreign related person had the sale or processing transaction been made between unrelated persons; and
(B) Any obligation of a non-EFS 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 § 1.7874–12 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 that is a controlled foreign corporation for its taxable year beginning January 1, 2017, but not for prior taxable years except as a result of a transaction described in the facts of an example. All entities have a calendar year tax year for U.S. tax purposes. FA acquired DT in an inversion transaction that was completed on January 1, 2015.


(B) Analysis. Pursuant to § 1.7874–12, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FS is a non-EFS foreign related person. In addition, FT acquired the FS obligation during the
obligation of FS is United States property with respect to 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 this paragraph (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 became a controlled foreign corporation with respect to which an expatriated entity, DT, is a United States shareholder. Accordingly, under § 1.7874–12(a)(9), FS is an expatriated foreign subsidiary, and is therefore not a non-EFS 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 this paragraph (a). FS is not excluded from the definition of expatriated foreign subsidiary pursuant to § 1.7874–12(a)(9)(ii) because FS was not a CFC on the completion date.

Example 3. (A) Facts. Before the inversion transaction, 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 EAG 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 § 1.7874–12(a)(9)(ii). Thus, pursuant to § 1.7874–12(a)(16), LFS is a non-EFS 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 this paragraph (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. LFSS 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 EAG with respect to the inversion transaction on the completion date, LFSS is not excluded from the definition of expatriated foreign subsidiary pursuant to § 1.7874–12(a)(9)(ii). Accordingly, under § 1.7874–12(a)(9)(ii), LFSS is an expatriated foreign subsidiary and is therefore not a non-EFS 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 paragraph (a) of this section. However, because LFSS is an expatriated foreign subsidiary, pursuant to § 1.7874–12(a)(9), the obligation of FS, a non-EFS foreign related person, is United States property with respect to LFSS for purposes of section 956(a) and this paragraph (a).

(c) ***(5) Special guarantee and pledge rule for expatriated foreign subsidiaries—(i) General rule. In applying paragraphs (c)(1) and (2) of this section to a controlled foreign corporation that is an expatriated foreign subsidiary, the phrase “of a United States person or a non-EFS 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-EFS foreign related person; and

(B) Applies to pledges or guarantees entered into, or treated pursuant to paragraph (c)(2) of this section as entered into—

(1) During the applicable period; or

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

(d) *** *(2) Obligation defined. For purposes of section 956 and this section, the term “obligation” includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not incurred, the acquirer was a 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 paragraph (a) of this section.

(f) [Reserved]. For further guidance, see § 1.956–2T(f).

(g) *** *(3) Except as otherwise provided in this paragraph (h)(3), 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-EFS foreign related person” in paragraph (a)(4)(i)(B) of this section, and paragraphs (a)(4)(ii)(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)(ii) of this section and this paragraph (h)(3), 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 (b)(3), 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.

(4) 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.

(5) 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 (b)(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.

(6) Paragraph (d)(2)(iv) of this section applies to obligations held on or after September 16, 1988. See § 1.956–2T(d)(2)(v), as contained in 26 CFR part 1 revised as of April 1, 2017, for additional rules applicable to certain taxable years of a foreign corporation beginning before January 1, 2011.

Par. 10. Section 1.956–2T is amended by:
1. Removing and reserving paragraph (a)(4).
2. Revising paragraphs (b)(2) through (c)(4).
3. Removing and reserving paragraphs (c)(5) and (d)(2).
4. Removing paragraphs (i) and (j).

The revisions read as follows:

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

* * * * *

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

* * * * *

Par. 11. Section 1.7701(l)–4 is added to read as follows:

§ 1.7701(l)–4 Rules regarding inversion transactions.

(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 definitions that apply for purposes of this section. Paragraph (f) of this section sets forth examples illustrating these rules. Paragraph (h) of this section provides applicability dates. See § 1.367(b)–4(e) and (f) for rules concerning certain other exchanges after an inversion transaction. See also § 1.956–2(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)–4(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 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 seriatrix 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 there-
after is treated as specified stock owned by
the specified related person for all pur-
poses 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 re-
characterized under paragraph (c)(2) or
(3) of this section, there is a direct or
indirect transfer of the disregarded spe-
cified stock in the expatriated foreign sub-
sidiary, and immediately after the transfer,
the expatriated foreign subsidiary is a for-
eign related person, then, to the extent
that, as a result of the transfer, the disre-
garded specified stock is actually held (de-
termined 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. share-
holder 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 trans-
ferred 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 pursu-
ant to paragraph (c)(2) or (3) of this sec-
tion) to the specified related person that
is treated as holding the deemed instru-
ments allocable to the out-of-group trans-
ferred disregarded specified stock, in redemp-
tion of the deemed instruments that are alloc-
able to the out-of-group transferred disre-
garded specified stock; and
(ii) The deemed issued stock that is
treated as transferred pursuant to para-
graph (d)(3)(i) of this section is treated as
recapitalized into the disregarded speci-
fied stock actually held by the specified
related person, which immediately there-
after is treated as specified stock owned
by the specified related person for all pur-
poses of the Internal Revenue Code. See
Example 7 and Example 11 of paragraph
(g) of this section.

(4) Certain direct transfers of disre-
garded specified stock to which unwind
rules do not apply. When a specified re-
lated person directly transfers the disre-
garded 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 disre-
garded specified stock, whether it is
in-group transferred disregarded specified
stock or out-of-group transferred disre-
garded specified stock, to the transferee of
the specified stock, in lieu of the disregarded
specified stock, in exchange for the consid-
eration 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 para-
graphs (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 speci-
fi ed 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 re-
f erred to in paragraph (d)(3) or (4) of this
section as a result of the specified trans-
action.

(ii) In-group direct transfers of disre-
garded specified stock. For purposes of
paragraph (d)(4) of this section, the por-
tion of the deemed issued stock treated
as owned by each section 958(a) U.S. share-
holder as a result of the specified transac-
tion that is allocable to in-group trans-
ferred disregarded specified stock is the
amount that is proportionate to the ratio of
the amount of the in-group transferred dis-
regarded specified stock to the amount of
disregarded specified stock of the expatri-
ated foreign subsidiary that is actually
held by the specified related person imme-
diately before the transfer described in
paragraph (d)(4) of this section as a result
of the specified transaction.

(e) Certain exception from foreign per-
sonal holding company income not avail-
able. An amount included in the gross
income of a controlled foreign corporation
as a dividend with respect to stock trans-
ferred in a specified transaction does not
qualify for the exception from foreign per-
sonal holding company income provided
by section 954(c)(6) (to the extent in ef-
fect).

(f) Definitions. In addition to the defi-
nitions in § 1.7874–12, the following defi-
nitions and special rules apply for pur-
poses of this section:

(1) Deemed instruments mean, with re-
spect to a specified transaction, instru-
m ents deemed issued by a section 958(a)
U.S. shareholder in exchange for trans-
ferred property in the specified transac-
tion.

(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. share-
holder (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 disre-
garded 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 cor-
poration 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-EFS foreign related person.

(5) In-group transferred disregarded
specified stock means disregarded speci-
fied 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 after a specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-EFS 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 a specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-EFS 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 that is a controlled foreign corporation for its taxable year beginning January 1, 2017, but not for prior taxable years. 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, FA is an expatriated foreign subsidiary, and FA and FS are non-EFS foreign related persons and specified related persons. All entities have a calendar year tax year for U.S. tax purposes.

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 even before its taxable year beginning January 1, 2017:

(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 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) of this section does not apply because there is no lower-tier expatriated foreign subsidiary. Although FA (a non-EFS 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), and as a result, under paragraph (f)(4) of this section, none of that stock is treated as directly or indirectly owned by FA 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-EFS 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-EFS foreign related persons) is 90% (90% - 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.

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(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 even before its taxable year beginning January 1, 2017.

(i) 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.

(ii) 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 own 50% of the capital and profits interests in DPRS, a domestic partnership. DPRS wholly owns FT3, a foreign corporation, which is thereafter treated as owned by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

(ii) Facts. The facts are the same as in Example 6 of this paragraph (g), except that 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.

(iii) 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 (50% x ($4x/$6x)) of the FT3 specified stock that is treated as being owned by FA, the specified related person, in redemption of $4x ($4x x ($4x/$6x)) of the DT deemed instruments that are treated as being owned by FA.

(F) The specified transactions with respect to FT, FT2, and FPRS are recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows:

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

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

(L) 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 7. (i) Facts. The facts are the same as in Example 7 of this paragraph (g), except that 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 x ($4x/$6x)) of the FT3 deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of $4x ($4x x ($4x/$6x)) of the DT deemed instruments that are treated as being owned by FA.

(F) The specified transactions with respect to FT, FT2, and FPRS are recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows:

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

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

(L) 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 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 $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 are treated as being owned by FA.

(F) The specified transactions with respect to FT, FT2, and FPRS are recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows:

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

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

(L) 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 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 $5x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $5x of DT deemed instruments that are treated as being owned by FA.

(F) The specified transactions with respect to FT, FT2, and FPRS are recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows:

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

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

(L) 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.
furred 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 x ($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 April 30, 2016 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 x ($6x/$6x)) of the FT deemed issued stock that it is treating as owned to FS, the specified related person, in redemption of $6x ($6x x ($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 recharacterization of the $6x of DT deemed instruments that FA is treating as owned, 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(1)–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.

§ 1.7701(1)–4T [Removed]

Par. 12. Section 1.7701(1)–4T is removed.

Par. 13. Section 1.7874–1 is amended by:

1. Adding a sentence at the end of paragraph (a).
2. Revising paragraph (c)(2)(iii).
3. Redesignating paragraphs (d) through (h) as paragraphs (e) through (i), respectively.
4. Adding a new paragraph (d).
5. Revising newly redesignated paragraphs (g) and (i)(2).
6. 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

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<tr>
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</tr>
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<td>(a), first sentence</td>
<td>expanded affiliated group</td>
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</tr>
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</table>
The revisions and additions read as follows:

§ 1.7874–1 Disregard of affiliate-owned stock.

(a) * * * For definitions that apply for purposes of this section, see 1.7874–12.

(c) * * *

(2) * * *

(iii) Special rule. If § 1.7874–6(c)(2) applies for purposes of applying section 7874(c)(2)(A) and this section, then, for purposes of paragraph (c)(2) of this section (and so much of paragraph (c)(1) of this section as relates to paragraph (c)(2) of this section), the determination of the EAG after the domestic entity acquisition, as well as the determination of stock held by one or more members of the EAG after the domestic entity 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 § 1.7874–6(c)(2)(i).

(d) Interaction of expanded affiliated group rules with other rules—(1) Exclusion rules. Stock that is excluded from the denominator of the ownership fraction pursuant to § 1.7874–4(b), 1.7874–7(b), 1.7874–8(b), 1.7874–9(b), or section 7874(c)(4) 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 paragraph (b) of this section and determining whether a domestic entity acquisition qualifies as an internal group restructuring or results in a loss of control, as described in paragraphs (c)(2) and (3) of this section, respectively. However, such stock is excluded from the denominator of the ownership fraction regardless of whether it otherwise would be included in the denominator of the ownership fraction as a result of the application of paragraph (c) of this section. See Example 8 and Example 9 of § 1.7874–4(i) for illustrations of the application of this paragraph (d)(1).

(2) NOCD rule. Stock of the foreign acquiring corporation treated as received by former domestic entity shareholders or former domestic entity partners, as applicable, under § 1.7874–10(b) is not 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 paragraph (b) of this section and determining whether a domestic entity acquisition qualifies as an internal group restructuring or results in a loss of control, as described in paragraphs (c)(2) and (3) of this section, respectively. However, such stock is included in the numerator and denominator of the ownership fraction, except to the

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<td>(b)</td>
<td>fraction that determines such percentage (ownership fraction)</td>
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<td>§ 1.7874–4, see § 1.7874–4(h)</td>
<td>other rules, see paragraph (d) of this section</td>
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<td>a domestic entity acquisition</td>
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<td>Before the domestic entity acquisition</td>
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<td>domestic entity acquisition</td>
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<td>(c)(3)</td>
<td>acquisition results in</td>
<td>foreign acquiring corporation</td>
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<td>(c)(3)</td>
<td>former shareholders or partners of the domestic entity</td>
<td>domestic entity acquisition results in</td>
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<td>acquisition</td>
<td>former domestic entity shareholders or former domestic entity partners</td>
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<td>domestic entity acquisition</td>
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<td>a domestic entity acquisition</td>
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</tr>
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</table>

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extent that it is treated as held by a member of the EAG and is excluded from the numerator or both the numerator and the denominator, as applicable, under section 7874(c)(2)(A) or paragraphs (b) or (c) of this section.

(g) Treatment of transactions related to the acquisition. Except as provided in paragraph (c)(2)(ii) of this section, all transactions that are related to an acquisition are taken into account in applying this section.

§ 1.7874–1T [Removed]

Par. 14. Section 1.7874–1T is removed.

Par. 15. Section 1.7874–2 is amended by:
1. Revising paragraph (a).
2. Removing the language “§ 1.7874–12T” in paragraph (b) introductory text, and adding the language “§ 1.7874–12” in its place.
3. Revising paragraphs (b)(7) through (13), (c)(2) and (4), (f)(1) introductory text, (f)(1)(iv), Example 21 of paragraph (k)(2), and paragraph (l)(2).

The revisions read as follows:

§ 1.7874–2 Surrogate foreign corporation.

(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. For additional definitions that apply for purposes of this section, see § 1.7874–12.

(b) * * *

(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) * * *

(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).

(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 paragraph (c) of this section other than paragraph (c)(2) of this section. For this purpose, the principles of paragraph (c)(1) of this section, including paragraph (b)(5) of this section, 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)).

(f) * * *

(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.

(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 paragraph (c) of this section other than paragraph (c)(2) of this section. For this purpose, the principles of paragraph (c)(1) of this section, including paragraph (b)(5) of this section, 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)).

(f) * * *

(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.

(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.

(k) * * *

(2) * * *

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 a tax resident (as described in §1.7874–3(d)(11)) 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 a tax 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 F1 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 acquisi-
Paragraph | Remove | Add
--- | --- | ---
(c)(1)(iii) | acquisition described in section 7874(a)(2)(B)(i) | domestic entity acquisition
newly redesignated (d)(1)(i) | acquisition date | completion date
newly redesignated (d)(1)(ii) | acquisition date | completion date
newly redesignated (d)(3), first, second, third, and fifth sentences | acquisition date | completion date
newly redesignated (d)(9) | foreign corporation described in section 7874(a)(2)(B) | foreign acquiring corporation
domestic entity acquisitions | domestic entity acquisition

The revisions and addition read as follows:

§ 1.7874–3 Substantial business activities.

*****
(b) ***
(4) Tax residence of foreign acquiring corporation. The foreign acquiring corporation is a tax resident of the relevant foreign country. However, this paragraph (b)(4) does not apply if the relevant foreign country does not impose corporate income tax.

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

*****
(8) 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 domestic entity acquisition, 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.

*****
(f) ***
(2) Paragraphs (b)(4), (d)(8), and (d)(11) of this section. The first sentence of paragraph (b)(4) of this section applies to domestic entity acquisitions completed on or after November 19, 2015, and the second sentence applies to domestic entity acquisitions completed on or after July 12, 2018. Paragraph (d)(8) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. Paragraph (d)(11) of this section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed on or after June 3, 2015, and before April 4, 2016, however, taxpayers may elect to apply paragraph (d)(8) of this section. For domestic entity acquisitions completed on or after November 19, 2015, and before July 12, 2018, taxpayers may elect to apply the second sentence of paragraph (b)(4) and paragraph (d)(11) of this section.

§ 1.7874–3T [Removed]

Par. 18. Section 1.7874–3T is removed.

Par. 19. Section 1.7874–4 is amended by:
1. Revising the seventh sentence of paragraph (a), and adding a sentence at the end of paragraph (a).
2. Revising paragraph (d)(1)(ii).
3. Removing paragraph (h).
4. Redesignating paragraphs (i), (j), and (k) as paragraphs (h), (i), and (j), respectively.
5. In newly redesignated paragraph (j)(1), removing the language “(d)(1)(ii),” from the fourth and seventh sentences and adding two sentences at the end of the paragraph.
6. 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.
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The revisions and addition read as follows:

§ 1.7874–4 Disregard of certain stock related to the domestic entity acquisition.

(a) ** * Paragraph (g) of this section provides rules for the treatment of partnerships, and paragraph (h) of this section provides definitions. ** * See § 1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1.

** * * * * *(d) ** * *(1) ** * *(ii) ** *

(ii) On the completion date, each five percent former domestic entity shareholder (or five percent former domestic entity partner) of the domestic entity acquisition, owned (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. For this purpose, a fivepercent former domestic entity shareholder (or five percent former domestic entity partner) is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity. See Example 5 of this paragraph (d) for an illustration of this paragraph (d).

** * * * * *(j) ** * *(1) ** * *(ii) ** *

(ii) Paragraph (d)(1)(ii) of this section applies to domestic entity acquisitions completed on or after July 12, 2018, though taxpayers may elect to consistently apply paragraph (d)(1)(ii) of this section to domestic entity acquisitions completed before July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see § 1.7874–4(d)(1)(ii) as contained in 26 CFR part 1 revised as of April 1, 2017.

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§ 1.7874–5 [Amended]

Par. 20. 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.
(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.

(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 § 1.7874–5(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 if 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 § 1.7874–12, 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 acquisi-
tion (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 domestic entity shareholder or former domestic entity 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 stock of a foreign acquiring corporation (DT acquisition) and distributes the stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) to Individual A pursuant to section 361(c)(1).

(ii) Analysis. The 100 FA shares received by Individual A are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under § 1.7874–5(a), the shares retain their status as such even though FA transfers 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)(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)(i) of this section is satisfied before 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)(ii) is satisfied because before the DT acquisition, 80 percent or more of the stock of FT (by vote and value) was transferred directly or indirectly by USS (the corporation that acquired the stock, and taking into account all transactions related to the acquisition, is the common parent of the EAG).

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 FT, a foreign corporation. FT owns 80 percent of the stock of USS (by vote and value) and distributes the FA stock to Individual A pursuant to section 361(c)(1). In a related transaction, USS transfers all the FA stock to USP, a newly formed foreign corporation, in exchange for 100 shares of stock of a foreign corporation, 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 Individual A are stock of a foreign acquiring corporation described in 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, 80 percent or more of the stock of FT (by vote and value) was transferred directly or indirectly by USS (the corporation that acquired the stock, 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 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 § 1.7874–5(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 (g) 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 FA 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 § 1.7874–1(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 § 1.7874–1(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 § 1.7874–4(b)(2)). 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.

(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. 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 (g) to domestic entity acquisitions completed before April 4, 2016.

§ 1.7874–6T [Removed]

Par. 22. Section 1.7874–6T is removed.

Par. 23. Section 1.7874–7 is added to read as follows:

§ 1.7874–7 Disregard of certain stock attributable to passive assets.

(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 by value. 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 definitions. Paragraph (f) of this section provides examples illustrating the application of the rules of this section. Paragraph (g) of this section provides dates of applicability. The rules provided in this section are also subject to section 7874(c)(4). See § 1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1.

(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, 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 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 § 1.7874–1(b), § 1.7874–4(b), § 1.7874–8(b), § 1.7874–9(b), or section § 7874(c)(4); 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 §§ 1.7874–4(b) and 1.7874–10(b), is less than five (by vote and value); and

(2) On the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group. For this purpose, a five percent former domestic entity shareholder (or five percent former domestic entity partner) that, before the domestic entity acquisition, owned (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 expanded affiliated group is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity.

(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) Definitions. In addition to the definitions provided in §1.7874–12, 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 §1.7874–4(h)(2), other than the following:

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

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

(II) 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 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 “controlled foreign corporation” for the term “controlled foreign corporation.”

(C) Property that gives rise to income described in section 1297(b)(2)(A) or (B) (determined without regard to other passive foreign investment company rules).

(D) Property held by a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter I 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 domestic entity acquisition, is acquired in exchange for other property, including cash, if such other property would be described in paragraph (e)(1)(i) of this section had the transaction not occurred.

(2) Foreign group property means any property (including excluded property, as described in paragraph (e)(3)(ii) of this section) 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—(i) In general. Foreign group nonqualified property fraction means a fraction calculated with the following numerator and denominator:

(A) The numerator of the fraction is the gross value of all foreign group nonqualified property, other than excluded property (as described in paragraph (e)(3)(ii) of this section).

(B) The denominator of the fraction is the gross value of all foreign group property, other than excluded property (as described in paragraph (e)(3)(ii) of this section).

(ii) Excluded property. For purposes of paragraph (e)(3) of this section, excluded property means property that gives rise to stock that is excluded from the ownership fraction with respect to the domestic entity acquisition under §1.7874–4(b), §1.7874–8(b), §1.7874–9(b), or section 7874(c)(4). For this purpose, only property that was directly or indirectly acquired in a prior domestic entity acquisition (as described in §1.7874–8(g)(4)) or covered foreign acquisition (as described in §1.7874–9(d)(4)) with respect to the domestic entity acquisition may be considered to give rise to stock that is excluded from the ownership fraction with respect to the domestic entity acquisition under §1.7874–8(b) or §1.7874–9(b). If only a portion of the consideration provided in a prior domestic entity acquisition or covered foreign acquisition consisted of stock of the foreign acquiring corporation, then only a pro rata portion of a property directly or indirectly acquired in the prior domestic entity acquisition or covered foreign acquisition may be considered excluded property, based on a fraction the numerator of which is the amount of the consideration that consisted of stock of the foreign acquiring corporation and the denominator of which is the total amount of consideration.

(4) Modified expanded affiliated group means, with respect to a domestic entity acquisition, the group described in either paragraph (e)(4)(i) of this section or paragraph (e)(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.

(f) 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 $500. On the completion date, in addition to the DT stock and Asset A, FA holds Asset B, which has a gross value of $150, and Asset C, which has a gross value of $100. Assets A and B, but not Asset C, are nonqualified property (within the meaning of §1.7874–4(h)(2)). 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 §1.7874–4(c) and are excluded from the denominator of the ownership fraction pursuant to §1.7874–4(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
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). Asset A is not taken into account for purposes of the foreign group nonqualified property fraction because it gives rise to FA stock that is excluded under § 1.7874–4(b) (4 shares) and, as a result, is excluded property. 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 by value is 76.84.

Example 2. Application 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 § 1.7874–4(h)(2)).

(ii) Analysis. Without regard to the application of § 1.7874–4(b) and 1.7874–10(b) as well as 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 $4/100$, 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 § 1.7874–4(h)(2)). Further, Asset B was not acquired in a transaction related to the DT acquisition in exchange for nonqualified property.

(ii) Analysis. Under paragraph (e)(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 (e)(4)(i) of this section). Under paragraph (e)(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.

Example 4. Coordination with serial acquisition rule—(i) Facts. Individual A owns all 30 shares of the sole class of stock of FA, a foreign corporation. In Year 1, FA acquires all the stock of DT1, a domestic corporation, solely in exchange for 40 shares of newly issued FA stock (DT1 acquisition). In Year 2, FA acquires all the stock of DT2, a domestic corporation, solely in exchange for 50 shares of newly issued FA stock (DT2 acquisition). On the completion date for the DT2 acquisition, in addition to the DT2 stock, FA holds Asset A, which has a gross value of $15x$, Asset B, which has a gross value of $15x$, and all the stock of DT1, which has a gross value of $40x$. At all times, DT1 holds only Asset C, which has a gross value of $30x$, and Asset D, which has a gross value of $10x$. Assets A and C, but not Assets B and D, are nonqualified property (within the meaning of § 1.7874–4(h)(2)). In addition, at all times, the fair market value of each share of FA stock is $1x$. Further, there have been no redemptions of FA stock subsequent to the DT1 acquisition. Lastly, under § 1.7874–8, the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition and $40x$ of FA stock is excluded from the denominator of the ownership fraction with respect to the DT2 acquisition.

(ii) Analysis. 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 $80x$ (the sum of the gross values of Assets A, B, C, and D), the gross value of all foreign group nonqualified property is $45x$ (the sum of the gross values of Assets A and C), and thus 56.25% of the gross value of all foreign group property constitutes foreign group nonqualified property ($45x$/80x). 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 $40x$ ($130x$, the value of all the shares of FA stock, less $50x$, the value of the stock described in section 7874(a)(2)(B)(ii), less $40x$, the value of the stock excluded under § 1.7874–8(b)) by the foreign group nonqualified property fraction. The property taken into account for purposes of determining the foreign group nonqualified property fraction is Asset A, Asset B, and the portion of Asset C and Asset D that is not excluded property. Eighty percent of each of Asset C and Asset D are considered excluded property because FA indirectly acquired Asset C and Asset D in the DT1 acquisition (a prior domestic entity acquisition with respect to the DT2 acquisition); as a result of that acquisition, $40x$ of FA stock is excluded from the denominator of the ownership fraction with respect to the DT2 acquisition under § 1.7874–8(b); and 80% of the consideration provided in the DT1 acquisition consisted of stock of FA ($40x$/50x). Thus, the numerator of the foreign group nonqualified property fraction is $15x$ (the gross value of Asset A) and the denominator is $30x$ (the sum of the gross values of Asset A, $15x$, and Asset B, $15x$). Accordingly, $15x$ of FA stock is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section ($30x$ multiplied by $15x$/30x). Thus, a total of $55x$ of FA stock is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section ($40x + 15x$), making the denominator $65x$ ($120x$ - $55x$). As a result, the ownership percentage with respect to the DT2 acquisition by value is 76.92 ($50x$/65x).
result, the ownership percentage with respect to D2 acquisition by value is 72.46 ($50x/$69x).

(g) Applicability dates. This section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see § 1.7874–7T, as contained in 26 CFR part 1 revised as of April 1, 2017. However, to the extent this section differs from § 1.7874–7T, as contained in 26 CFR part 1 revised as of April 1, 2017, taxpayers may elect to consistently apply the differences to domestic entity acquisitions completed before July 12, 2018.

§ 1.7874–7T [Removed]

Par. 24. Section 1.7874–7T is removed.

Par. 25. Section 1.7874–8 is added to read as follows:

§ 1.7874–8 Disregard of certain stock attributable to serial acquisitions.

(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. This section applies after taking into account § 1.7874–2(e). See § 1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1.

(b) General rule. This paragraph (b) applies to a domestic entity acquisition (relevant domestic entity acquisition) when the foreign acquiring corporation (including a predecessor, as defined in § 1.7874–10(f)(1)) 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 § 1.7874–12, 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
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).

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) did not exceed $50 million, as determined on the completion date with respect to the domestic entity acquisition.

De minimis. A domestic entity acquisition is described in this paragraph (g)(4)(ii)(A) or (B) of this section.

(A) De minimis. A domestic entity acquisition is described in this paragraph (g)(4)(ii)(A) if—

(1) 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

(2) The fair market value of the stock of the foreign acquiring corporation 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.

(B) Foreign-parented group. A domestic entity acquisition is described in this paragraph (g)(4)(ii)(B) if—

(1) Before the domestic entity acquisition and any related transaction, the domestic entity was a member of a foreign-parented group (as described in § 1.7874–6(f)(1)); and

(2) The domestic entity acquisition qualified for the internal group restructuring exception under § 1.7874–1(c)(2).

A redeemed share means a share of stock in a relevant share class that was redeemed (within the meaning of section 317(b)).

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.

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, because there were no redemptions of FA stock, 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). 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 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) (150 shares x $1.50x per share)). In addition, the denominator of the ownership fraction is $375x (calculated as $525x, the fair market value of all 350 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 ($225x divided by $375x).

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 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) (150 shares x $1.50x per share)), and the denominator of the ownership fraction is $337.50x (calculated as $450x, the fair market value of all 300 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 ($225x divided by $337.50x).

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 increased 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 share 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 stock during the redemption testing period). When a domestic entity completes a covered foreign acquisition, the denominator of the ownership fraction is $225x (the fair market value of the stock of FA stock on the completion date with respect to the DT2 acquisition). The denominator of the ownership fraction is $225x (the fair market value of the stock of FA stock on the completion date with respect to the DT2 acquisition). Therefore, the ownership percentage by value is 66.67 ($225 divided by $337.50x).

(i) Applicability dates. Except as provided in this paragraph (i), this section applies to domestic entity acquisitions completed on or after April 4, 2016, regardless of when a prior domestic entity acquisition was completed. Paragraphs (g)(3) and (g)(4)(ii) of this section apply to domestic entity acquisitions completed on or after July 12, 2018. However, taxpayers may elect to consistently apply paragraphs (g)(3) and (g)(4)(ii) of this section to domestic entity acquisitions completed on or after April 4, 2016, and before July 12, 2018. For domestic entity acquisitions completed on or after April 4, 2016, and before July 12, 2018, see § 1.7874–8T(g)(3) and (g)(4)(ii) as contained in 26 CFR part 1 revised as of April 1, 2017.

§ 1.7874–8T [Removed]

Par. 26. Section 1.7874–8T is removed.

Par. 27. Section 1.7874–9 is added to read as follows:

§ 1.7874–9 Disregard of certain stock in third-country transactions.

(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.

(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 a tax resident of the foreign country in which the acquired foreign corporation was a tax resident before the covered foreign acquisition and all related transactions.

(3) The ownership percentage described in section 7874(a)(2)(B)(ii), 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 § 1.7874–12, 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—(i) In general. Except as provided in paragraphs (d)(4)(ii) and (iii) of this section, a 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.

(ii) Substantial business activities exception. A foreign acquisition is not a covered foreign acquisition if, on the completion date, the following requirements are satisfied:

(A) The foreign acquiring corporation is a tax resident of a foreign country.

(B) The expanded affiliated group has substantial business activities in the country in which the foreign acquiring corporation is a tax resident when compared to the total business activities of the expanded affiliated group. For this purpose, the principles of § 1.7874–3 apply and the determination of whether there are sub-
stantial business activities is made without regard to the domestic entity acquisition.

(iii) **No income tax exception.** A foreign acquisition is not a covered foreign acquisition if—

(A) Before the acquisition and all related transactions, the acquired foreign corporation was created or organized in, or under the law of, a foreign country that does not impose corporate income tax and was not a tax resident of any other foreign country; and

(B) After the acquisition and all related transactions are complete, the foreign ac-

quiring corporation is created or organized in, or under the law of, a foreign country that does not impose corporate income tax and is not a tax resident of any other foreign country.

(5) A **tax resident** of a foreign country has the meaning set forth in § 1.7874–

3(d)(11).

(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 the same plan (or a series of related trans-

actions) and two or more of the acquired foreign corporations were tax residents of the same foreign country before the foreign acquisitions and all related trans-

actions, then those foreign acquisitions are treated as a single foreign acquisition and those acquired foreign corporations are treated as a single acquired foreign corpo-

ration 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 mul-

tiple 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 de-

termining the proportionate amount of properties indirectly acquired), apply by substituting the term “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 “do-

mestic” 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 §§ 1.7874–2, 1.7874–4, 1.7874–5, 1.7874–7, and section 7874(c) (4)) with the following modifications:

(i) Stock of a foreign acquiring corpo-

ration described in section 7874(a)(2)(B) is not taken into account.

(ii) The principles of this section, section 7874(c)(2)(A), and §§ 1.7874–1,

1.7874–6, 1.7874–8, and 1.7874–10 do not apply.

(iii) The principles of § 1.7874–7 apply by, in addition to the exclusions listed in § 1.7874–7(e)(2)(i) through (iii), also excluding from the definition of foreign group property any property held directly or indirectly by the acquired foreign cor-

poration immediately before the foreign acquisition and directly or indirectly ac-

quired 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 rea-

son of holding stock in an acquired foreign corporation, the principles of section 7874(a)(2)(B)(i) and §§ 1.7874–2(f) and 1.7874–5 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 a tax resident is treated as a transaction. Further, for pur-

poses of this section, if a foreign acquiring corporation changes the country in which it is a tax resident in a manner that would not otherwise be considered to result in a foreign acquisition (for example, by chang-

ing where it is managed and controlled), then the foreign acquiring corporation is treated as—

(i) Both an acquired foreign corporation and a foreign acquiring corporation; and

(ii) Directly or indirectly acquiring all of the properties held directly or indirectly by the acquired foreign corporation solely in exchange for stock of the foreign ac-

quiring corporation.

(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 a tax 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 a tax 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). After the FT acquisition and all related transactions, the expanded affiliated group does not have substantial business activities in Country Y when compared to the total business activities of the expanded affiliated group, as determined under the principles of § 1.7874–3 and without regard to the DT 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 acquiring 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. Accord-

ingly, the FT acquisition is a covered foreign acquisi-

tion. 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 a tax resident (Country Y) is different than the foreign country in which FT was 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 a tax 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 a tax resident (Country Y) is different than the foreign country of which FT was a tax 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 a tax 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 (35/35). See § 1.7874–2(f)(1)(i) and paragraphs (e)(3) and (4) of this section. Accordingly, because the FT acquisition case is pursuant to a paragraph 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. This section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see § 1.7874–9T, as contained in 26 CFR part 1 revised as of April 1, 2017. However, to the extent this section differs from § 1.7874–9T, as contained in 26 CFR part 1 revised as of April 1, 2017, taxpayers may elect to consis-

tently apply the differences to domestic entity acquisitions completed before July 12, 2018.

§ 1.7874–9T [Removed]
Par. 28. Section 1.7874–9T is removed.
Par. 29. Section 1.7874–10 is added to read as follows:

§ 1.7874–10 Disregard of certain distributions.

(a) Scope. This section identifies distributions made by a domestic enterprise that are disregarded in determining an ownership fraction. Paragraph (b) of this section provides the general rule that former domestic enterprise shareholders or former domestic enterprise partners are treated as receiving additional stock of the foreign acquiring corporation when the domestic enterprise 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 rules regarding the allocation of NOCD stock. Paragraph (i) of this section addresses cases in which there are multiple foreign acquiring corporations, and paragraph (j) of this section addresses cases in which multiple domestic enterprises are treated as a single domestic enterprise. Paragraph (k) of this section provides definitions.

(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 enterprise shareholders or former domestic enterprise 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) (NOCD stock) is in addition to stock of the foreign acquiring corporation otherwise treated as received by the former domestic enterprise shareholders or former domestic enterprise 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 §§ 1.7874–4(b) and 1.7874–7(b), is less than five (by vote and value); and

(2) On the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (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. For this purpose, a five percent former domestic entity shareholder (or five percent former domestic entity partner) is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity.
(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 (k)(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 1.7874–5 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 1.7874–6 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 1.7874–6 do not apply; and

(B) The principles of §§ 1.7874–4 and 1.7874–7 through 1.7874–9 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 owned by the distributing corporation and any related person (determined under section 7874(d)(3), without regard to whether the person is foreign) 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) Allocation of NOCD stock. NOCD stock is allocated among the former domestic entity shareholders or former domestic entity partners, as applicable, based on the amount of NOCDs that the former domestic entity shareholders or former domestic entity partners, as applicable, are treated as having received under this paragraph (h). Under this paragraph (h), a pro rata portion of each distribution during a look-back year is treated as comprising an NOCD with respect to the look-back year, based on a fraction the numerator of which is the amount of NOCDs during the look-back year and the denominator of which is the amount of distributions during the look-back year. Thus, each former domestic entity shareholder or former domestic entity partner, as applicable, is treated as receiving an amount of NOCD stock equal to the amount of NOCDs treated as received by the former domestic entity shareholder or former domestic entity partner, as applicable.

(i) Multiple foreign acquiring corporations. If there are multiple foreign acquiring corporations with respect to a domestic entity acquisition, then the foreign acquiring corporation or corporations as to which NOCD stock is considered comprised is based on the proportion of consideration directly or indirectly provided by a foreign acquiring corporation in the domestic entity acquisition relative to the total amount of consideration directly or indirectly provided by the foreign acquiring corporations in the domestic entity acquisition. For purposes of this paragraph (i), consideration is not considered directly or indirectly provided by a foreign acquiring corporation if it was indirectly provided by another foreign acquiring corporation. In addition, for purposes of this paragraph (i), consideration provided in the domestic entity acquisition does not include money
or other property described in paragraph (k)(1)(iii) of this section.

(j) Multiple domestic entities. If pursuant to § 1.7874–2(e) two or more domestic entities are treated as a single domestic entity, then the determination of the amount of NOCDs made by the single domestic entity is made by—

(1) Applying the rules of this section to each domestic entity on a separate basis, with the result that the amount of NOCDs made by each domestic entity is separately computed; and

(2) Treating the amount of NOCDs made by the single domestic entity as the sum of the separately computed NOCDs made by each domestic entity.

(k) Definitions. In addition to the definitions provided in § 1.7874–12, 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 (k)(1)(iii) and (iv) of this section, a distribution pursuant to section 361(c)(1) (other than a distribution to which section 355 applies).

(ii) Any distribution by a partnership (other than a distribution pursuant to section 752(b) to the extent that the transaction giving rise to such distribution does not reduce the partnership’s value).

(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 (k)(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.

(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 (k)(5)(ii)(A) of this section; and

(C) The period, if any, that immediately precedes the period described in paragraph (k)(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 (k)(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.

(l) Applicability date. This section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see § 1.7874–10T, as contained in 26 CFR part 1 revised as of April 1, 2017. However, to the extent this section differs from § 1.7874–10T, as contained in 26 CFR part 1 revised as of April 1, 2017, taxpayers may elect to consistently apply the differences to domestic entity acquisitions completed before July 12, 2018.

§ 1.7874–10T [Removed]

Par. 30. Section 1.7874–10T is removed.

Par. 31. Section 1.7874–11 is added to read as follows:

§ 1.7874–11 Rules regarding inversion gain.

(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.
(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 domestic entity acquisition, 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 domestic entity acquisition, of property that is described in section 1221(a)(1) in the hands of the transferee 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 § 1.7874–12 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, acquired 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), 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.

§ 1.7874–11T [Removed]

Par. 32. Section 1.7874–11T is removed.

Par. 33. Section 1.7874–12 is added to read as follows:

§ 1.7874–12 Definitions.

(a) Definitions. Except as otherwise provided, the following definitions apply for purposes of this section and §§ 1.367(b)–4, 1.956–2, 1.7701(i)–4, and 1.7874–1 through 1.7874–11.

(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 § 1.7874–2(b)(13) in the case of a subsequent acquisition (or a similar acquisition under the principles of § 1.7874–2(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, and a reference to a member of the EAG includes a predecessor with respect to such member.

(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 (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person) and in which an expatriated entity is a United States shareholder (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned
by a person who is not a United States person).

(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 (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person) and a member of the EAG; and

(B) On or before the completion date, the domestic entity was not a United States shareholder (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person) 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-EFS 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-EFS foreign related person;

(ii) A domestic partnership in which a non-EFS foreign related person is a partner; and

(iii) A domestic trust of which a non-EFS 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. The following apply to domestic entity acquisitions completed on or after April 4, 2016: paragraph (a)(8) of this section; in paragraph (a)(6) 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"; and the second sentence of paragraph (a)(10) of this section. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, however, taxpayers, may elect to apply the provisions in the immediately prior sentence.

§ 1.7874–12T [Removed]

Par. 34. Section 1.7874–12T is removed.

Kirsten Wielobob
Deputy Commissioner for Services and Enforcement.

Approved: June 22, 2018

David J. Kautter
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on July 11, 2018, 8:45 a.m., and published in the issue of the Federal Register for July 12, 2018, 83 F.R. 32524)
Part III. Administrative, Procedural, and Miscellaneous

Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

Notice 2018–60

This notice provides guidance on the corporate bond monthly yield curve, the corresponding spot segment rates used under § 417(e)(3), and the 24-month average segment rates under § 430(h)(2) of the Internal Revenue Code. In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning before 2008 and the 30-year Treasury weighted average rate under § 431(c)(6)(E)(ii)(I).

YIELD CURVE AND SEGMENT RATES

Section 430 specifies the minimum funding requirements that apply to single-employer plans (except for CSEC plans under § 414(y)) pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan’s target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates (“segment rates”), each of which applies to cash flows during specified periods. To the extent provided under § 430(h)(2)(C)(iv), these segment rates are adjusted by the applicable percentage of the 25-year average segment rates for the period ending September 30 of the year preceding the calendar year in which the plan year begins. However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates.

Notice 2007–81, 2007–44 I.R.B. 899, provides guidelines for determining the monthly corporate bond yield curve, and the 24-month average corporate bond segment rates used to compute the target normal cost and the funding target. Consistent with the methodology specified in Notice 2007–81, the monthly corporate bond yield curve derived from June 2018 data is in Table 2018–06 at the end of this notice. The spot first, second, and third segment rates for the month of June 2018 are, respectively, 3.12, 4.20, and 4.60.

The 24-month average segment rates determined under § 430(h)(2)(C)(i) through (iii) must be adjusted pursuant to § 430(h)(2)(C)(iv) to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates. For plan years beginning before 2021, the applicable minimum percentage is 90% and the applicable maximum percentage is 110%. The 25-year average segment rates for plan years beginning in 2017 and 2018 were published in Notice 2016–54, 2016–40 I.R.B. 429, and Notice 2017–50, 2017–41 I.R.B. 280, respectively.

24-MONTH AVERAGE CORPORATE BOND SEGMENT RATES

The three 24-month average corporate bond segment rates applicable for July 2018 without adjustment for the 25-year average segment rate limits are as follows:

<table>
<thead>
<tr>
<th>24-Month Average Segment Rates Without 25-Year Average Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable Month</td>
</tr>
<tr>
<td>July 2018</td>
</tr>
</tbody>
</table>

Based on § 430(h)(2)(C)(iv), the 24-month averages applicable for July 2018, adjusted to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates, are as follows:

<table>
<thead>
<tr>
<th>Adjusted 24-Month Average Segment Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>For Plan Years Beginning In</td>
</tr>
<tr>
<td>2017</td>
</tr>
<tr>
<td>2018</td>
</tr>
</tbody>
</table>

30-YEAR TREASURY SECURITIES INTEREST RATES

Section 431 specifies the minimum funding requirements that apply to multiemployer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in § 431(c)(6)(A), based on the plan’s current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this purpose must be no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate. The rate of interest on 30-year Treasury securities for June 2018 is 3.05 percent. The Service determined this rate as the average of the daily

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1Pursuant to § 433(h)(3)(A), the 3rd segment rate determined under § 430(h)(2)(C) is used to determine the current liability of a CSEC plan (which is used to calculate the minimum amount of the full funding limitation under § 433(c)(7)(C)).
determinations of yield on the 30-year Treasury bond maturing in May 2048. For plan years beginning in July 2018, the weighted average of the rates of interest on 30-year Treasury securities and the permissible range of rates used to calculate current liability are as follows:

<table>
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<th>For Plan Years Beginning In</th>
<th>30-Year Treasury Weighted Average</th>
<th>Permissible Range</th>
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<tr>
<td>July 2018</td>
<td>2.86</td>
<td>90% to 105%</td>
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<table>
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<tr>
<th>Month</th>
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<td>3.12</td>
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MINIMUM PRESENT VALUE SEGMENT RATES

In general, the applicable interest rates under § 417(e)(3)(D) are segment rates computed without regard to a 24-month average. Notice 2007–81 provides guidelines for determining the minimum present value segment rates. Pursuant to that notice, the minimum present value segment rates determined for June 2018 are as follows:

DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS participated in the development of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Tony Montanaro at 202-317-8698 (not toll-free numbers).
Table 2018–6
Monthly Yield Curve for June 2018
Derived from June 2018 Data

<table>
<thead>
<tr>
<th>Maturity</th>
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<th>Maturity</th>
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Clarification Concerning the Effect of Section 67(g) on Trusts and Estates

Notice 2018–61

SECTION 1. PURPOSE

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue regulations providing clarification of the effect of newly enacted section 67(g) of the Internal Revenue Code (Code) on the deductibility of certain expenses described in section 67(b) and (e) and § 1.67–4 of the Income Tax Regulations that are incurred by estates and non-grantor trusts. Section 67(g) was added by “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115–97 (Act), which was enacted December 22, 2017. This notice also requests comments on issues relating to section 642(h)(2) and § 1.642(h)–2(a) in light of new section 67(g).

SECTION 2. BACKGROUND

Section 11045 of the Act added section 67(g) to the Code, which generally provides that, notwithstanding section 67(a), no miscellaneous itemized deductions shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

Section 61(a) defines gross income as all income from whatever source derived, including (but not limited to) the items listed in sections 61(a)(1) through (15), except as otherwise provided in subtitle A.

Section 62(a) defines the term “adjusted gross income” for purposes of subtitle A as, in the case of an individual, gross income minus the deductions listed in sections 62(a)(1) through (21).

Section 63(a) defines “taxable income” for individuals who itemize their deductions, for purposes of substitute A, as gross income minus the deductions allowed by chapter 1 (other than the standard deduction).

Section 63(d) defines the term “itemized deductions” for purposes of substitute A as the deductions allowable under chapter 1 other than (1) the deductions allowable in arriving at adjusted gross income, (2) the deduction for personal exemptions provided by section 151, and (3) the deduction provided in section 199A.

Section 67(a) provides generally that, in the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

Section 67(b) defines the term “miscellaneous itemized deductions” for purposes of section 67 as meaning the itemized deductions other than those listed in sections 67(b)(1) through (12).

Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or trust shall be computed in the same manner as that of an individual, except that (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust, and (2) the deductions allowable under sections 642(b), 651, and 661 shall be treated as allowable in arriving at adjusted gross income.

Section 1.67–4(a) states that section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in the administration of an estate or a trust not described in § 1.67–2T(g)(1)(i) (a non-grantor trust) and that would not have been incurred if the property were not held in such estate or trust. A cost is subject to the 2-percent floor to the extent that it is included in the definition of miscellaneous itemized deductions.

Section 1.67–4(b) provides generally that, in analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual holding the same property, it is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative. It further provides specific examples of costs that will be considered commonly or customarily incurred by individuals and those that will not.

Section 1.67–4(c) provides that, subject to certain exceptions, if an estate or non-grantor trust pays a single fee, commission, or other expense for both costs that are subject to the 2-percent floor and costs (in a more than de minimis amount) that are not, then, except to the extent provided otherwise by guidance published in the Internal Revenue Bulletin, the single fee, commission, or other expense (bundled fee) must be allocated, for purposes of computing the adjusted gross income of the estate or non-grantor trust in compliance with section 67(e), between the costs that are subject to the 2-percent floor and those that are not.

SECTION 3. REGULATIONS TO BE ISSUED ADDRESSING THE EFFECT OF SECTION 67(g) ON CERTAIN ESTATE AND NON-GRACTOR TRUST EXPENSES

Commentators have suggested that new section 67(g) might be read to eliminate the ability of estates and non-grantor trusts to deduct any expenses described in section 67(e)(1) and § 1.67–4 for the taxable years during which the application of section 67(a) is suspended. The Treasury Department and the IRS do not believe that this is a correct reading of section 67(g). For the taxable years during which it is effective, section 67(g) denies a deduction for miscellaneous itemized deductions. Section 67(b) defines miscellaneous itemized deductions as itemized deductions other than those listed therein. Section 63(d) defines itemized deductions by excluding personal exemptions, section 199A deductions, and deductions used to arrive at adjusted gross income. Therefore, neither the above-the-line deductions used to arrive at adjusted gross income nor the expenses listed in section 67(b)(1) – (12) are miscellaneous itemized deductions. Section 62(a) defines adjusted gross income of an individual, and section 67(e) provides that the adjusted gross income of a trust or estate is determined in the same way as for an individual, except that expenses described in section 67(e)(1) and deductions pursuant to sections 642(b), 651, and 661 are allowable as deductions in arriving at adjusted gross income. Thus, section 67(e) removes the expenses de-
scribed in section 67(e)(1) from the category of itemized deductions (and thus necessarily also from the subset of miscellaneous itemized deductions) and instead treats them as above-the-line deductions allowable in determining adjusted gross income under section 62(a). Therefore, the suspension of the deductibility of miscellaneous itemized deductions under section 67(a) does not affect the deductibility of payments described in section 67(e)(1). However, an expense that commonly or customarily would be incurred by an individual (including the appropriate portion of a bundled fee) is affected by section 67(g) and thus is not deductible to the estate or non-grantor trust during the suspension of section 67(a). Nothing in section 67(g) impacts the determination of what expenses are described in section 67(e)(1).

Additionally, nothing in section 67(g) affects the ability of the estate or trust to take a deduction listed under section 67(b). These deductions remain outside of the definition of “miscellaneous itemized deduction.” For example, section 691(c) deductions (relating to the deduction for estate tax on income in respect of the decedent), which are identified in section 67(b)(7), remain unaffected by the enactment of section 67(g).

The Treasury Department and the IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses described in section 67(e)(1) and amounts allowable as deductions under section 642(b), 651 or 661, including the appropriate portion of a bundled fee, in determining the estate or non-grantor trust’s adjusted gross income during taxable years, for which the application of section 67(a) is suspended pursuant to section 67(g). Additionally, the regulations will clarify that deductions enumerated in section 67(b) and (e) continue to remain outside the definition of “miscellaneous itemized deductions” and thus are unaffected by section 67(g).

SECTION 4. REQUEST FOR COMMENTS CONCERNING A BENEFICIARY’S ABILITY TO CLAIM EXCESS DEDUCTIONS PURSUANT TO SECTION 642(h)

The Treasury Department and the IRS are aware of some concerns that the enactment of section 67(g) will affect a beneficiary’s ability to deduct section 67(e) expenses upon the termination of the trust or estate as provided in section 642(h).

Section 642(h) provides that if, on the termination of an estate or trust, the trust or estate has: (1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or (2) for the last taxable year of the estate or trust, deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income for such year, then such carryover or such excess shall be allowed as a deduction, in accordance with the regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust.

Section 1.642(h)–1(b) provides, in part, that net operating loss carryovers and capital loss carryovers are taken into account when determining adjusted gross income. Therefore, they are above-the-line deductions and thus are not miscellaneous itemized deductions on the returns of beneficiaries. Conversely, § 1.642(h)–2(a) provides that if, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction (section 642(h)(2) excess deduction) to the beneficiaries. However, the section 642(h)(2) excess deduction is allowed only in computing the taxable income of the beneficiaries and must be taken into account in computing the items of tax preference of the beneficiaries. Therefore, a section 642(h)(2) excess deduction is not used in computing the beneficiaries’ adjusted gross income and is treated as a miscellaneous itemized deduction of the beneficiaries. See sections 63(d) and 67(b).

The section 642(h)(2) excess deduction may include expenses described in section 67(e). As previously discussed, prior to enactment of section 67(g), miscellaneous itemized deductions were allowed subject to the restrictions contained in section 67(a). For the years in which section 67(g) is effective, miscellaneous itemized deductions are not permitted, and that appears to include the section 642(h)(2) excess deduction. The Treasury Department and the IRS are studying whether section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the trust or estate, should continue to be treated as miscellaneous itemized deductions when they are included as a section 642(h)(2) excess deduction. Taxpayers should note that section 67(e) provides that appropriate adjustments shall be made in the application of part I of subchapter J of chapter 1 of the Code to take into account the provisions of section 67.

The Treasury Department and the IRS intend to issue regulations in this area and request comments regarding the effect of section 67(g) on the ability of the beneficiary to deduct amounts comprising the section 642(h)(2) excess deduction upon the termination of a trust or estate in light of sections 642(h) and 1.642(h)–2(a). In particular, the Treasury Department and the IRS request comments concerning whether the separate amounts comprising the section 642(h)(2) excess deduction, such as any amounts that are section 67(e) deductions, should be separately analyzed when applying section 67. Written comments may be submitted by U.S. Postal Service to Internal Revenue Service, CC: PA:LPD:RU (Notice 2018–61), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044, or by hand delivery (between the hours of 8:00 am to 4:00 pm) to CC:PA:LPD:RU (Notice 2018–61), Courier’s Desk, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224. Comments may also be submitted by email to Notice.Comments@irs.counsel.treas.gov. Comments submitted by email should include Notice 2018–61 in the subject line as well as in the body of the email. Comments will be available for public inspection and copying.

SECTION 5. EFFECTIVE DATE

This notice is effective July 13, 2018. Estates and non-grantor trusts may rely on this notice for taxable years beginning after December 31, 2017.
SECTION 6. DRAFTING INFORMATION

The principal author of this notice is Meghan M. Howard of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact Ms. Howard at (202) 317-5279 (not a toll-free number).

[26 CFR 1.6033–2]: Returns by exempt organizations and returns by certain non-exempt organizations (Also: §§ 6001, 6033, and § 1.6001–1)

Rev. Proc. 2018–38

SECTION 1. PURPOSE

This document contains procedures modifying the information to be reported to the IRS by organizations exempt from tax under § 501(a) of the Internal Revenue Code (Code), other than organizations described in § 501(c)(3), that are required to file an annual Form 990 or Form 990–EZ information return. These organizations are no longer required to report the names and addresses of their contributors on the Schedule B of their Forms 990 or 990–EZ. These organizations, however, must continue to collect and keep this information in their books and records and to make it available to the IRS upon request, when needed for tax administration.

SECTION 2. BACKGROUND

Section 6001 of the Code requires any person subject to tax under the Code to keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, the Secretary may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title. Specifically for organizations exempt from tax under § 501(a) (tax-exempt organizations), § 1.6001–1(c) provides that such organizations shall keep such permanent books of account or records as are sufficient to show specifically the items of gross income, receipts, and disbursements.

Section 6033(a) requires certain tax-exempt organizations to file annual information returns that include gross income, receipts and disbursements, and such other information required by forms or regulations. The annual information returns required under § 6033 are Forms 990, “Return of Organization Exempt From Income Tax,” 990–EZ, “Short Form Return of Organization Exempt From Income Tax,” 990–PF, “Return of Private Foundation,” and 990–BL, “Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.” Section 6033(b) provides that tax-exempt organizations described in § 501(c)(3) that are subject to the requirements of § 6033(a) must furnish information annually setting forth certain items including, “the total of the contributions and gifts received by it during the year, and the names and addresses of all substantial contributors.”

Although the statute does not address contributor reporting by tax-exempt organizations other than those described in § 501(c)(3), the implementing regulations under § 6033(a) generally require all types of tax-exempt organizations to report the names and addresses of all persons who contribute $5,000 or more in a year under § 1.6033–2(a)(2)(ii)(f). Section 1.6033–2(a)(2)(ii)(d) also requires organizations described in § 501(c)(7) (generally, social clubs), (8) (generally, fraternal beneficiary societies), or (10) (generally, domestic fraternal societies) to report the name of each person who contributed more than $1,000 during the taxable year to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

The regulation that extends contributor reporting requirements to all types of tax-exempt organizations also authorizes the Commissioner to grant relief from those requirements. Specifically, § 1.6033–2(g)(6) authorizes the Commissioner to “relieve any organization or class of organizations (other than an organization described in § 509(a)(3)) from filing, in whole or in part the annual return required by this section where [the Commissioner] determines that such returns are not necessary for the efficient administration of the internal revenue laws.”

Under existing rules, the names and addresses of contributors for all types of organizations are reported on Schedule B, “Schedule of Contributors,” filed with Forms 990, 990–EZ, and 990–PF, or, with respect to organizations described in § 501(c)(21), in Part IV of Form 990–BL.

In general, under § 6104(b), the Secretary must make the annual returns filed under § 6033 available to the public. However, the Secretary is not authorized to disclose the name or address of any contributor to any tax-exempt organization other than a private foundation (as defined in § 509(a), including trusts described in § 4947(a)(1) that are treated as private foundations) or a § 527 organization. Further, § 301.6104(b)–1(b)(2) provides that even if the names and addresses are not disclosed, the amounts of contributions to an organization shall be made available for public inspection unless the disclosure of such information can reasonably be expected to identify any contributor.

In addition to the required disclosure by the Secretary, § 6104(d) and § 301.6104(d)–1 require certain tax-exempt organizations to provide their annual information returns upon request by a member of the public. Similar to the restrictions on disclosing contributor information placed on the Secretary by § 6104(b), an organization, other than a private foundation or a § 527 organization, is not required to disclose the names and addresses of its contributors under § 6104(d)(3)(A).

2Likewise, section 6033(a)(3)(B) provides a discretionary exception from the annual filing requirement under which the Secretary may relieve any organization (other than a supporting organization described in § 509(a)(3)) otherwise required to file an information return from filing such a return if the Secretary determines that the filing is not necessary to the efficient administration of the internal revenue laws.
SECTION 3. APPLICATION

In exercising his discretion under § 1.6033–2(g)(6), the Commissioner balances the IRS’s need for the information against the costs and risks associated with reporting of the information. The IRS does not need personally identifiable information of donors to be reported on Schedule B of Form 990 or Form 990–EZ in order for it to carry out its responsibilities. The requirement to report such information increases compliance costs for some private parties, consumes IRS resources in connection with the redaction of such information, and poses a risk of inadvertent disclosure of information that is not open to public inspection.

Accordingly, tax-exempt organizations required to file the Form 990 or Form 990–EZ, other than those described in § 501(c)(3), will no longer be required to provide names and addresses of contributors on their Forms 990 or Forms 990–EZ and thus will not be required to complete these portions of their Schedules B (or complete the similar portions of Part IV of the Form 990–BL). Similarly, organizations described in § 501(c)(7), (8), or (10) will no longer be required to provide on Forms 990 or Forms 990–EZ the names and addresses of persons who contributed more than $1,000 during the taxable year to be used for exclusively charitable purposes. This revenue procedure does not affect the information required to be reported on Forms 990, 990–EZ, or 990–PF by organizations described in § 501(c)(3) (which for purposes of § 6033 include nonexempt charitable trusts described in § 4947(a)(1) and nonexempt private foundations described in § 6033(d)) or political organizations described in § 527.

This revenue procedure does not affect the reporting of contribution information, other than the names and addresses of contributors, required to be reported on Schedule B of Forms 990 and 990–EZ and Part IV of the Form 990–BL. This revenue procedure does not affect the disclosure requirements under § 6104(b) or (d) of any information reported on the Schedule B of Forms 990 and 990–EZ and Part IV of the Form 990–BL. As a result, this revenue procedure will have no effect on the reporting of Schedule B information that is currently open to public inspection. Organizations relieved of the obligation to report contributors’ names and addresses must continue to keep this information in their books and records in order to permit the IRS to efficiently administer the internal revenue laws through examinations of specific taxpayers.

SECTION 4. EFFECTIVE DATE

The revised reporting requirements of this revenue procedure will apply to information returns for taxable years ending on or after December 31, 2018. Thus, the revised reporting requirements generally will apply to returns that become due on or after May 15, 2019.

SECTION 5. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0047. Please refer to the Paperwork Reduction Act statement accompanying Form 990 Instructions, for further information.

An organization is not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents can become material in the administration of any Internal Revenue law.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Jonathan Carter of the Office of Associate Chief Counsel (Tax-Exempt and Government Entities). However, other personnel from the office of the Associate Chief Counsel (Tax-Exempt and Government Entities) participated in its development. For further information regarding this revenue procedure contact Jonathan Carter at (202) 317-5800 (not a toll-free number).
Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with modified, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with amplified and clarified, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revised describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, modified and superseded describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspected is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.I.—City.
C.O.O.P.—Cooperative.
C.D.—Court Decision.
C.Y.—County.
D—Decedent.
D.C.—Dummy Corporation.
D.E.—Donee.
D.el. O. —Delegation Order.
DISC—Domestic International Sales Corporation.
D.R.—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
E.X.—Executor.
F—Fiduciary.
F.C.—Foreign Country.
F.P.H.—Foreign Person Holding Company.
F.R.—Federal Register.
F.X.—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
G.—Grantee.
G.P.—General Partner.
G.R.—Grantor.
I.C.—Insurance Company.
L.E.—Lessee.
L.P.—Limited Partner.
L.R.—Lesser.
M.—Minor.
N.—Nonacquiescence.
O.—Organization.
P.—Parent Corporation.
P.H.C.—Personal Holding Company.
P.O.—Possession of the U.S.
P.R.—Partner.
P.R.S.—Partnership.
P.T.E.—Prohibited Transaction Exemption.
Pub. L.—Public Law.
R.E.I.T.—Real Estate Investment Trust.
R. V.—Revenue Procedure.
R. V. R.—Revenue Ruling.
S.—Subsidiary.
S.t.—Statutes at Large.
T.—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
T.F.E.—Transferor.
T.R.—Transferor.
T.P.—Taxpayer.
T.R.—Trust.
T.T.—Trustee.
X.—Corporation.
Y.—Corporation.
Z.—Corporation.
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1A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–01 through 2018–26 is in Internal Revenue Bulletin 2018–26, dated June 27, 2018.
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\(^{1}\)A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–01 through 2018–26 is in Internal Revenue Bulletin 2018–26, dated June 27, 2018.
The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at www.irs.gov/irb/.

We Welcome Comments About the Internal Revenue Bulletin

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page (www.irs.gov) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.