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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

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Section 1248 Attribution Principles

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1248 of the Internal Revenue Code (Code) that provide guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions. The proposed regulations are necessary in order to supplement and clarify existing guidance in the regulations under section 1248. The proposed regulations affect persons subject to the regulations under section 1248, as well as persons to which regulations under other Code provisions, such as section 367(b), apply to the extent that those regulations incorporate the principles of the proposed regulations. In addition, the proposed regulations provide that with respect to the sale by a foreign partnership of the stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation for purposes of section 1248.

DATES: Written or electronic comments and requests for a public hearing must be received by August 30, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-135866-02), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-135866-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington DC or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS-REG-135866-02).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Michael Gilman at (202) 622-3850 (not a toll-free number); concerning the submissions of comments and request for hearing, Richard Hurst at Richard.A.Hurst@irscounsel.treas.gov (preferred) or at (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

Section 1248(a) of the Code provides that certain gain recognized on the sale or exchange of stock of a foreign corporation by a United States person will be included in the gross income of that person as a dividend if: (1) the foreign corporation was a controlled foreign corporation at any time during the five-year period ending on the date of the sale or exchange; and (2) the United States person owned or is considered to have owned, within the meaning of section 958, 10 percent or more of the total combined voting

power of the foreign corporation at any time during that five-year period (section 1248 shareholder). The amount of gain included in income as a dividend under section 1248(a) is limited to the earnings and profits attributable to the stock that is sold or exchanged which were accumulated in taxable years of the foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by the United States person while the foreign corporation was a controlled foreign corporation. A distribution treated as an exchange of stock is also included. See §1.1248-1(b). In addition, section 1248 may also apply to certain distributions of the stock of a foreign corporation as provided under section 1248(f).

The section 1248 regulations provide for both a simple case method and a complex case method for computing a controlled foreign corporation's earnings and profits attributable to stock disposed of in a transaction to which section 1248 applies. See §§1.1248-2 and 1.1248-3. A taxpayer may use the simple case method under §1.1248-2, which requires few adjustments in the earnings and profits calculation under section 1248, if it meets several criteria (e.g., the foreign corporation has only one class of stock and a constant number of shares outstanding on each day of each post-1962 taxable year which falls within the relevant holding period). If these criteria are not satisfied, a taxpayer must use the complex case method under §1.1248-3. The complex case method provides additional rules to address situations involving multiple classes of stock, changes in a shareholder's ratable share of a corporation's earnings and profits, and other complicating factors.

Under §1.1248-1(a), the period of ownership of stock of a United States person for purposes of attributing earnings and profits to that stock includes the period that the United States person actually held the stock or is considered to have held such stock pursuant to section 1223. Section 1223(1) provides that the period for which the taxpayer has held property received in an exchange, shall include the period for which the taxpayer held the property exchanged if the property received in the exchange has the same basis in whole or in part in the taxpayer's hands as the property exchanged. Section 1223(2) provides that the period for which the taxpayer is considered to have held property acquired shall include the period for which that property was held by any other person if the property acquired has the same basis in whole or in part in the taxpayer's hands as it would have in the hands of that other person.

Section 1248(c)(2) generally provides that, if the United States person selling, exchanging, or distributing stock in a foreign corporation has the required ownership interest in lower-tier foreign corporations, certain earnings and profits of those lower-tier foreign corporations will be attributed to stock of the foreign corporation that the U.S. person sells, exchanges, or distributes. For this provision to apply, the United States person must have owned or be considered to have owned, within the meaning of section 958, 10 percent or more of the total combined voting power of the lower-tier foreign corporation at any time during the five-year period preceding the sale.

Although section 1248(a) applies only to sales or exchanges of stock in a foreign corporation by a United States person, section 964(e) applies section 1248 principles to

certain dispositions of stock in a foreign corporation by a controlled foreign corporation. Section 964(e)(1) provides that if a controlled foreign corporation that owns stock in a foreign corporation sells or exchanges such stock, gain recognized on such sale or exchange shall be included in the gross income of such controlled foreign corporation as a dividend to the same extent that it would have been included under section 1248(a) if the controlled foreign corporation were a United States person.

Section 367(b) addresses certain exchanges described in sections 351, 354, 355, 356, and 361 that do not involve a transfer of property described in section 367(a). One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248. See H. R. Rep. No. 94-658, 94th Cong., 1st Sess., at 242 (November 12, 1975). Regulations under section 367(b) require certain exchanging shareholders to include in income as a deemed dividend the section 1248 amount attributable to stock of a foreign corporation as a result of an acquisition by a foreign corporation of the stock or assets of a foreign corporation in an exchange described in section 351 or a reorganization described in section 368(a)(1). For example, an exchanging shareholder must include the section 1248 amount attributable to the stock exchanged in income if the exchange results in its loss of status as a section 1248 shareholder. See §1.367(b)-4(b)(1). For this purpose, the section 1248 amount generally is determined by reference to the amount that would be included in income as a dividend under section 1248 and the regulations under that section if the stock were sold by the exchanging shareholder. See §1.367(b)-2(c).

Explanation of Provisions

A. Scope

The Treasury Department and the IRS believe that it is important that the section 1248 regulations make explicit that only the appropriate amount of earnings and profits are attributed to stock of a foreign corporation for purposes of section 1248 following relevant nonrecognition transactions. The proposed regulations provided in §1.1248-8 supplement and clarify the existing rules under §§1.1248-2 and 1.1248-3. The results obtained under the proposed regulations are consistent with the results provided under section 1248 and the existing regulations under sections 367(b) and 1248. However, some taxpayers have raised concerns that those existing regulations may attribute an excessive amount of earnings and profits to stock after certain nonrecognition transactions. The Treasury Department and the IRS believe that this view is not a correct interpretation of the existing regulations. Nevertheless, in order to remove this uncertainty, the proposed regulations clarify how the principles of section 1248 should be applied so that a section 1248 shareholder or a foreign corporation to which section 964(e) applies includes the appropriate amount in income as a dividend upon the sale or exchange of stock of a current or former controlled foreign corporation.

The proposed regulations provide rules for accurately attributing earnings and profits to stock of a foreign corporation that is received by an exchanging shareholder, or received by an acquiring corporation, pursuant to one or more restructuring transactions in which the holding period of such stock is determined by application of section 1223(1) or

1223(2), and in which the exchanging shareholder is not required, as a result of the exchange, to include in income the section 1248 amount pursuant to §1.367(b)-4(b). The proposed regulations also provide rules for attributing earnings and profits to stock of a foreign corporation that participates in a restructuring transaction that is held by a non-exchanging shareholder in such a restructuring transaction.

For purposes of the proposed regulations, a restructuring transaction is a transaction that qualifies as a nonrecognition transaction (within the meaning of section 7701(a)(45)) under section 351, 354, 356, or 361. The proposed regulations provide special rules for liquidations described in section 332 and consequently, these transactions are not included in the definition of a restructuring transaction. An exchanging shareholder is defined in the proposed regulations as a person that, in a restructuring transaction qualifying for nonrecognition under section 354, 356, or 361(a), exchanges stock of an acquired corporation for stock in either a foreign acquiring corporation or a foreign corporation that is in control of the acquiring corporation. In a restructuring transaction qualifying for nonrecognition under section 351, the proposed regulations define an exchanging shareholder as a person that exchanges property (including stock) for stock in a foreign acquiring corporation. An acquiring corporation is defined in the proposed regulations as a corporation that, in a restructuring transaction, acquires the stock or assets of an acquired corporation. For purposes of the proposed regulations, a foreign corporate shareholder is a foreign corporation that owns stock of another foreign corporation, and has a section 1248 shareholder that is also a section 1248 shareholder of

the other foreign corporation. A non-exchanging shareholder is defined in the proposed regulations as a person that, at the time of the restructuring transaction, is either a section 1248 shareholder or a foreign corporate shareholder of

the acquiring corporation and that is not an exchanging shareholder with respect to that corporation.

The proposed regulations also set forth rules for the attribution of earnings and profits for purposes of section 1248 with respect to stock of a foreign corporation that receives assets and liabilities of a foreign corporation in a complete liquidation described in section 332 if the foreign distributee is a foreign corporate shareholder of the liquidating corporation. In addition, the proposed regulations provide that with respect to the sale by a foreign partnership of the stock of certain foreign corporations, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporations for purposes of section 1248. Finally, the proposed regulations provide additional rules to ensure the proper attribution of earnings and profits to stock of controlled foreign corporations or foreign corporate shareholders as a result of certain nonrecognition transactions.

B. Attribution of Earnings and Profits to Stock in a Foreign Corporation as a Result of a Restructuring Transaction

1. Earnings and profits attributable to the stock that an exchanging shareholder receives

Some taxpayers have expressed concern that an excessive amount of earnings and profits could be attributed to stock that an exchanging shareholder receives in a restructuring transaction under the existing section 1248 regulations through the application of the holding period rules of section 1223(1). For example, in a transaction described in section 351, a domestic corporation (DC1) contributes property to a foreign acquiring

corporation (FA) in exchange for 80 percent of the voting stock in FA. Prior to the transaction, FA was wholly owned by another domestic corporation (DC2). Assume in the transaction that DC1 does not recognize gain under section 367(a) and the regulations under that section or include income under section 367(b) and the regulations under that section. The basis of the stock in FA received by DC1 in the transaction will be determined pursuant to section 358, and in determining DC1's holding period in the FA stock, DC1 will include, under section 1223(1), the period DC1 held the property it contributed to FA. Some taxpayers incorrectly interpret the existing section 1248 regulations to require that, if DC1 subsequently sells or exchanges the FA stock received in the restructuring transaction, the earnings and profits accumulated by FA before the transaction (i.e., before DC1's period of actual ownership of the FA stock), but within the section 1223(1) holding period, are attributed to the FA stock received and sold by DC1. This interpretation would result in the inappropriate attribution of such accumulated earnings and profits to the FA stock held by both DC2 and DC1 (if DC2 sells or exchanges its FA stock, the accumulated earnings and profits of FA that were attributed to the FA stock sold by DC1 would correctly be attributed under the existing section 1248 regulations to the FA stock held by DC2).

This interpretation of the existing section 1248 regulations is not correct and any such double attribution is not intended. However, to provide greater certainty, the proposed regulations clarify that excessive attribution of earnings and profits does not occur as a result of restructuring transactions. The proposed regulations provide that

where an exchanging shareholder receives, in a restructuring transaction, stock in a foreign corporation, the holding period of which is determined under section 1223(1), and the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately after the restructuring transaction, the earnings and profits attributable to the stock the exchanging shareholder receives shall be determined on the basis of the type of property exchanged.

If the property exchanged is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder immediately before the transaction, the earnings and profits attributable to the foreign corporation stock received by the exchanging shareholder shall be determined in accordance with §1.1248-2 or §1.1248-3 (whichever is applicable) without regard to any portion of the section 1223(1) holding period in that stock that reflects periods prior to the restructuring transaction.

If, on the other hand, the property exchanged is stock in a foreign acquired corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to the foreign corporation immediately before the transaction, the proposed regulations provide that the earnings and profits attributable to the stock received by the exchanging shareholder shall equal the sum of the earnings and profits attributable to: (1) the stock of the foreign acquired corporation accumulated prior to the restructuring transaction; and (2) the stock of the foreign corporation that the exchanging shareholder receives in the restructuring transaction

without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. The earnings and profits attributable to any portion of the section 1223(1) holding period in the foreign acquiring stock that is prior to the restructuring transaction remain attributable through the operation of the existing section 1248 regulations to the foreign acquiring stock held by non-exchanging shareholders. See proposed §1.1248-8(b)(4) and (7), Example 2.

The proposed regulations provide an exception to this general rule, however, in certain triangular reorganizations involving a foreign issuing corporation that controls a domestic acquiring corporation. This exception applies, for example, where a United States person (DC) exchanges its stock in a foreign acquired corporation (FS) for stock of a foreign issuing corporation (FI) that controls the domestic acquiring corporation (DA) in a restructuring transaction (i.e., a triangular reorganization described in section 368(a)(1)(B)). To prevent the attribution of FS's pre-acquisition earnings and profits to stock owned by both DC and DA, the proposed regulations provide that the earnings and profits attributable to the FI stock received by DC shall consist solely of the earnings and profits attributable to the FI stock received (determined under §1.1248-2 or §1.1248-3, whichever is applicable, and proposed §1.1248-8, if applicable) without regard to any portion of DC's section 1223(1) holding period in the FI stock received that includes periods of time prior to the restructuring transaction. See proposed §1.1248-8(b)(7), Example 5. As discussed in paragraph (B)(2) of this preamble, the earnings and profits attributable to the FS stock for periods before the triangular

reorganization generally are attributed to the FS stock owned by DA after the transaction.

2. Earnings and profits attributable to stock in a foreign corporation that certain acquiring corporations receive

In addition to potential excessive attribution resulting from section 1223(1) holding periods discussed above, some taxpayers are concerned that an excessive amount of earnings and profits could be attributed to stock under the existing section 1248 regulations through the application of the section 1223(2) holding period rules to an acquiring corporation in a restructuring transaction. For example, in a transaction described in section 351, a foreign corporation (FP) that owns 100 percent of the stock of another foreign corporation (FS) and 100 percent of the stock of a domestic corporation (DC), transfers its FS stock to DC. Prior to the transaction, FP was not a section 1248 shareholder or a foreign corporate shareholder with respect to FS. DC's basis in the FS stock received by DC in the restructuring transaction will be determined pursuant to section 362, and in determining DC's holding period in the FS stock, DC will include, under section 1223(2), the period FP held the FS stock. Some taxpayers incorrectly interpret the existing section 1248 regulations to require that if DC subsequently sells or exchanges the FS stock received in the restructuring transaction, the earnings and profits accumulated by FS before the transaction (i.e., before DC's period of actual ownership of the FS stock), but within the 1223(2) holding period, are attributed to the FS stock received and sold by DC. This interpretation would result in the attribution of earnings and profits to the FS stock held by DC even though such earnings and profits were accumulated by FS when it was not a

controlled foreign corporation.

Such interpretation of the existing section 1248 regulations is not correct. However, to provide greater certainty, the proposed regulations clarify that excessive attribution of earnings and profits does not occur as a result of such transactions. The proposed regulations provide that where, in a restructuring transaction, an acquiring corporation receives stock in a foreign acquired corporation, the holding period of which is determined under section 1223(2), and the acquiring corporation is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign acquired corporation immediately after the restructuring transaction, the earnings and profits attributable to the foreign acquired corporation stock that the acquiring corporation receives shall be determined depending on whether the exchanging shareholder was a section 1248 shareholder or a foreign corporate shareholder with respect to the acquired corporation. If the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder with respect to the foreign acquired corporation immediately before the restructuring transaction, the proposed regulations provide that the earnings and profits attributable to the stock of the foreign acquired corporation shall be determined in accordance with §1.1248-2 or §1.1248-3 (whichever is applicable) without regard to any portion of the section 1223(2) holding period in that stock that is prior to the restructuring transaction.

However, in a restructuring transaction where the acquiring corporation receives stock of a foreign acquired corporation with respect to which an exchanging shareholder is

either a section 1248 shareholder or a foreign corporate shareholder immediately before the transaction, the proposed regulations modify the approach discussed above in order to ensure the proper amount of earnings and profits is attributable to stock that the acquiring corporation receives. For example, assume a domestic corporation (DC1) has owned all the stock of a foreign corporation (FS) since its formation. In a transaction described in section 368(a)(1)(B), DC1 transfers all its FS stock to another domestic corporation (DC2), in exchange for DC2 voting stock. The section 1248 amount attributable to the FS stock is \$100 but section 367(b) does not require DC1 to include it in income as a deemed dividend. See §1.367(b)-4(a) (income inclusion rules only apply when there is a foreign acquiring corporation). If DC2 subsequently recognizes gain upon the sale or exchange of its stock in FS and if the earnings and profits attributable to that stock do not include the earnings and profits that accumulated before DC2's actual period of ownership, then those earnings and profits would escape inclusion in income as a dividend under section 1248.

To ensure the proper attribution of earnings and profits in these situations, the proposed regulations provide that where the stock exchanged in the restructuring transaction is stock of a foreign corporation, with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder immediately before the restructuring transaction, the earnings and profits attributable to the stock of the acquired corporation will be determined with regard to the portion of the section 1223(2) holding period in that stock that the exchanging shareholder took into

account for purposes of attributing earnings and profits to that stock. See proposed §1.1248-8(b)(7), Example 3 and Example 5.

3. Earnings and profits attributable to stock held by a non-exchanging shareholder

The proposed regulations generally provide that the earnings and profits attributable to stock of an acquiring corporation held by a non-exchanging shareholder immediately prior to a restructuring transaction continue to be attributed to such stock, and the earnings and profits of the acquired corporation accumulated prior to the restructuring transaction attributable to the stock of an acquired corporation are not attributed to the non-exchanging shareholder's stock in the acquiring corporation. See proposed §1.1248-8(b)(7), Example 2 and Example 4.

However, a special rule applies to a nonexchanging shareholder that owns stock in a foreign corporation that is both an acquiring corporation and an exchanging shareholder in the same restructuring transaction (i.e., an upstream merger). This rule is necessary because the acquiring corporation does not receive stock in exchange for its stock in the acquired corporation and, as a result, the general attribution rules in the proposed regulations would not preserve the earnings and profits attributable to such acquired corporation stock. For example, assume a domestic corporation (DC) owns all the stock of a controlled foreign corporation (CFC1), CFC1's only asset is 79 percent of the stock of another controlled foreign corporation (CFC2), and the other 21 percent of the CFC2 stock is owned by an unrelated party (X). Pursuant to a restructuring transaction described in section 368(a)(1)(C), CFC2 transfers all its assets to CFC1. In exchange, CFC1 assumes

the liabilities of CFC2 and transfers to CFC2 voting stock representing 21 percent of the stock of CFC1. CFC2 distributes the voting stock to X and liquidates. In such a transaction, the earnings and profits attributable to the CFC1 stock held by DC (i.e., the nonexchanging shareholder) shall be the sum of the earnings and profits attributable to the stock of CFC1 (i.e., the foreign acquiring corporation) immediately before the restructuring transaction (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of CFC1 accumulated after the restructuring transaction (including amounts attributed under section 1248(c)(2)). See proposed §1.1248-8(b)(7),

Example 8. Cf. proposed §1.1248-8(c) (providing similar rules for liquidations described in section 332).

4. Reduction in earnings and profits attributable to stock to prevent multiple inclusions with respect to the same earnings and profits

The proposed regulations require that, to the extent consistent with the principles of section 1248, adjustments to earnings and profits attributable to stock shall be made so that section 1223(1) and (2) and the proposed regulations are applied in a manner that results in earnings and profits being taken into account only once. Accordingly, the proposed regulations provide that upon the sale by a controlled foreign corporation of stock of another foreign corporation to which earnings and profits had been attributed under the rules of the proposed regulations, proportionate reductions shall be made to the earnings and profits attributed to the stock of the selling foreign corporate shareholder owned by a section 1248 shareholder. See proposed §1.1248-8(b)(7), Example 7. For example, assume a section 1248 shareholder owns 80 percent of a controlled foreign corporation (CFC1) and an unrelated foreign person owns the remaining 20 percent of CFC1. The section 1248 shareholder receives the CFC1 stock in exchange for the stock of its wholly owned foreign subsidiary (CFC2) in a restructuring transaction described in section 368(a)(1)(B). Immediately before the transaction, \$100 of earnings and profits is attributable to the CFC2 stock owned by the section 1248 shareholder. As previously discussed, the proposed regulations provide for the attribution of the \$100 of CFC2's pre-acquisition earnings and profits to the CFC1 stock received by the section 1248 shareholder in the transaction and to the CFC2 stock received by CFC1 in the transaction. Assume that CFC2 accumulates another \$100 of earnings and profits after the

transaction, and in a subsequent year, CFC1 sells 30 percent of its stock in CFC2. If the requirements of section 964(e) are met, CFC1 will include in its gross income as a dividend \$30 of CFC2's pre-acquisition earnings and profits and \$30 of CFC2's post-acquisition earnings and profits. In order to prevent the attribution of a portion of these earnings and profits to the section 1248 shareholder's stock in CFC1, the proposed regulations provide that the earnings and profits attributable to the section 1248 shareholder's stock in CFC1 will be reduced by \$54, \$24 (80 percent of \$30) of the earnings and profits accumulated by CFC2 after the restructuring transaction and \$30 of the earnings and profits accumulated by CFC2 prior to the restructuring transaction.

5. Special rule regarding section 381

The proposed regulations also provide a special rule in order to avoid possible double counting of earnings and profits as a result of the operation of section 381(a) in a restructuring transaction and the proposed rules. Under section 381, an acquiring corporation succeeds to and takes into account the earnings and profits of the transferor or distributor corporation as of the close of the day of the transfer or distribution. Because the earnings and profits carry over from one corporation to another corporation at the close of the day, the same earnings and profits accumulated by the transferor or distributor corporation before the transaction could also be considered to have been accumulated by the transferee or distributee corporation after the transfer or distribution. For example, assume a domestic corporation (DC1) owns 100 percent of controlled foreign corporation (CFC1) that generates \$100 of earnings and profits. CFC1 merges into another controlled

foreign corporation (CFC2) in a reorganization described in section 368(a)(1)(A), and DC1 receives 25 percent of the CFC2 stock in exchange for its CFC1 stock in the merger. If, for purposes of section 1248, the \$100 of earnings and profits of CFC1 is attributable to the CFC2 stock received by DC1, and is also taken into account by CFC2 pursuant to section 381, the same \$100 of earnings and profits would be taken into account twice.

Except with respect to upstream mergers, the proposed regulations attribute the pre-acquisition earnings and profits of the transferor, where appropriate, to the stock received by the exchanging shareholder. Therefore, in order to prevent the double counting of earnings and profits, the proposed regulations provide that earnings and profits of another corporation to which the foreign corporation succeeded through the operation of section 381 will not be attributed to its stock. See proposed §1.1248-8(b)(6) and (7), Example 4, and (c)(2) and (3).

6. Attribution of earnings and profits following certain liquidations

Under the existing section 1248 regulations, issues have arisen as to whether the so-called hovering deficit rule under section 381(c)(2)(B) applies for purposes of attributing earnings and profits to stock of the foreign distributee corporation following certain liquidations of foreign corporations under section 332. The hovering deficit rule generally restricts access to certain deficits in earnings and profits following section 381 transactions. The Treasury Department and the IRS believe that the hovering deficit rule should not apply in these types of section 332 liquidations because section 1248(c)(2) generally provides for the attribution of a foreign subsidiary's earnings and profits

(including any deficits) to the stock of its foreign parent. Thus, the foreign parent already had, in effect, access to the deficit of the foreign subsidiary pursuant to section 1248(c)(2) prior to the section 332 liquidation. In that case, application of the hovering deficit rule is not appropriate for section 1248 purposes.

Accordingly, the proposed regulations provide a special rule that clarifies application of the hovering deficit rule to a distributee foreign corporate shareholder in a section 332 liquidation. In this circumstance, the earnings and profits of the distributing foreign corporation to which the foreign distributee corporation succeeds through the operation of section 381 will not be taken into account by the foreign distributee for purposes of section 1248 and consequently, the hovering deficit rule will not apply. Instead, the proposed regulations provide a rule for attributing earnings and profits of the foreign liquidating corporation to the stock of the foreign distributee in such a liquidation that is consistent with the principles of section 1248(c)(2). In such a case, the earnings and profits attributable to the distributee stock shall be the sum of: (1) the earnings and profits attributable to the stock of the distributee immediately before the liquidation (including amounts attributed under section 1248(c)(2)); and (2) the earnings and profits attributable to the stock of the distributee accumulated after the liquidation (including amounts attributed under section 1248(c)(2)). See proposed §1.1248-8(b)(7), Example 3, and (c).

C. Sale or Exchange of Stock by a Foreign Partnership

A domestic partnership is treated as a United States person for purposes of section 1248. See section 7701(a)(30)(B) and §1.1248-1(a)(1). Accordingly, the sale by a

domestic partnership of the stock of a foreign corporation is subject to section 1248(a). Section 1248 and the existing regulations do not, however, address specifically sales or exchanges of stock by foreign partnerships with United States persons as partners.

The legislative history of subchapter K of the Code provides that, for purposes of interpreting Code provisions outside of that subchapter, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular Code section under consideration. H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954).

The purpose of section 1248 is to ensure that earnings and profits of controlled foreign corporations (or former controlled foreign corporations) are taxed as a dividend when certain United States persons recognize gain on the sale or exchange of stock in such corporations. In cases in which the United States person is a partner in a foreign partnership and recognizes income on the sale of stock of a foreign corporation by such foreign partnership, the purpose of section 1248 is fulfilled only if the partnership is treated as an aggregate for section 1248 purposes. Treatment of a foreign partnership as an entity, in contrast, could result in partners in the partnership inappropriately receiving capital gain treatment on the sale by the partnership of stock of the foreign corporation.

Thus, under proposed §1.1248-1(a)(4), a foreign partnership is treated as an aggregate of its partners for purposes of section 1248(a). Under the proposed regulations, for example, the partners in a foreign partnership shall be treated as selling or exchanging their proportionate share of stock held by the foreign partnership. The

proposed regulations also apply section 1248(a) in cases where the stock in a corporation that is sold or exchanged is held through tiers of foreign partnerships. This treatment of the foreign partnership as an aggregate, rather than as an entity, for purposes of applying section 1248 is necessary to reflect properly the attributable earnings and profits as a dividend.

D. Removal of Rule under §1.367(b)-2(d)(3)(ii) Limiting Amounts Attributable to Holding Periods Determined under Section 1223

Section 1.367(b)-3 requires that an exchanging shareholder, as defined in §1.367(b)-3(b)(1), include the all earnings and profits amount (as defined generally in §1.367(b)-2(d)) in income as a deemed dividend (with respect to its stock in the foreign acquired corporation) when a domestic corporation acquires the assets of the foreign corporation in a section 332 liquidation or a section 368(a)(1) asset acquisition. Section 1.367(b)-2(d)(3)(ii) excludes, for purposes of determining the all earnings and profits amount, amounts attributable to holding periods determined under section 1223(2) during which there was no direct or indirect ownership by a United States person. Pursuant to §1.367(b)-2(d)(3)(i)(A)(1), the all earnings and profits amount with respect to stock of a foreign corporation is determined according to the attribution principles of section 1248 and the regulations under that section. Since the rules of proposed §1.1248-8(b)(2) conform to the rule set forth in §1.367(b)-2(d)(3)(ii), the proposed regulations remove paragraph (d)(3)(ii) from §1.367(b)-2.

E. Revision of §1.367(b)-4(d) Providing Rules for Subsequent Exchanges

Section 1.367(b)-4 applies to an acquisition by a foreign corporation of the stock or assets of a foreign corporation in an exchange described in section 351 or a reorganization described in section 368(a)(1). If the exchange meets certain criteria, an exchanging shareholder, as defined in §1.367(b)-4(b)(1)(i)(A), must include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges. If in a particular exchange, income is not required to be included pursuant to §1.367(b)-4(b), §1.367(b)-4(d) provides rules governing the attribution of earnings and profits to the stock received by the exchanging shareholder in the non-inclusion exchange for purposes of applying section 367(b) or section 1248 to subsequent sales or exchanges of that stock.

Because proposed §1.1248-8 provides rules for the attribution of earnings and profits to stock with respect to the §1.367(b)-4(b) non-inclusion exchanges, the proposed regulations remove the substantive rules and examples in §1.367(b)-4(d) from the final regulations. In their place, taxpayers are referred to proposed §1.1248-8.

F. Effective Date.

These regulations are proposed to apply to income inclusions that occur on or after the date that final regulations are published in the **Federal Register**.”

G. Request for Comments

1. Attribution to stock shareholder receives by gift

The proposed regulations do not apply to determine the earnings and profits attributable to stock in a foreign corporation that a United States person receives as a gift. The Treasury Department and the IRS seek comments as to whether additional guidance

is needed to address the attribution of earnings and profits with respect to stock of a foreign corporation that a United States person receives by gift.

2. Attribution of earnings and profits to stock shareholder receives under section 355

The proposed regulations do not apply to determine the earnings and profits attributable to stock in a foreign corporation that a United States person receives in a distribution to which section 355 applies. The Treasury Department and the IRS seek comments as to whether additional guidance is needed to address the attribution of earnings and profits with respect to stock of a foreign corporation that a United States person receives in such distributions.

3. Effect on §§1.1248-4 and 1.1248-5

The proposed regulations do not address the interaction of proposed §1.1248-8 with §§1.1248-4 and 1.1248-5. The Treasury Department and the IRS seek comments as to whether additional guidance on how the proposed regulations should affect those sections of the existing regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of 5 U.S.C. chapter 5 does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act, 5 U.S.C. chapter 6, does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Requests for a Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be made available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that submits timely

written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of the proposed regulations are Michael I. Gilman of the Office of Associate Chief Counsel (International) and Mark R. Pollard, formerly of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

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

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

Sections 1.367(b)-2(c)(1) and (2) and (d)(3), and 1.367(b)-4(d) also issued under 26 U.S.C. 367(b)(1) and (2).* * *

Sections 1.1248-1(a)(1), (4), and (5), and 1.1248-8 also issued under 26 U.S.C. 1248(a) and (c)(1) and (2).* * *

§1.367(b)-2 [Amended]

Par. 2. Section 1.367(b)-2 is amended by:

1. Amending the last sentence of paragraph (c)(1)(ii) by removing the language “, as modified by §1.367(b)-4(d) (as applicable)” and adding the language “. See §1.1248-8.” in its place.

2. Removing Example 4 in paragraph (c)(2).

3. Amending the last sentence of paragraph (d)(3)(i)(B)(2) by removing the language “, as modified by paragraph (d)(3)(ii) of this section and §1.367(b)-4(d) (as applicable)” and adding the language “. See §1.1248-8.” in its place.

4. Removing paragraph (d)(3)(ii).

5. Redesignating paragraph (d)(3)(iii) as paragraph (d)(3)(ii).

Par. 3. Section 1.367(b)-4(d) is revised to read as follows:

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

certain nonrecognition transactions.

* * * * *

(d) Rules for subsequent sales or exchanges. 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) of this section in a section 367(b) exchange described in paragraph (a) of this section (non-inclusion exchange), then, for purposes of applying section 367(b) or section 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 shall be determined pursuant to the rules of section 1248 and the regulations under that section.

Par. 4. Section 1.1248-1 is amended by:

1. Amending the first sentence of paragraph (a)(1) by removing the language “(or was considered as held by reason of the application of section 1223)” and adding the language “(or was considered as held by reason of the application of section 1223, taking into account §1.1248-8)” in its place.
2. Adding a new third sentence in paragraph (a)(1).
3. Redesignating paragraph (a)(4) as paragraph (a)(5).
4. Adding new paragraph (a)(4).
5. Adding Example 4 in newly designated paragraph (a)(5).

The additions read as follows:

§1.1248-1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) In general. (1) * * * See §1.1248-8 for additional rules regarding the attribution of earnings and profits to the stock of a foreign corporation following certain nonrecognition transactions. * * *

* * * * *

(4) For purposes of paragraph (a)(1) of this section, stock of a corporation that is owned by a foreign partnership shall be considered as owned proportionately by its partners. Consequently, if a foreign partnership sells or exchanges stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation. Stock considered to be owned by a partner by reason of the application of the first sentence of this paragraph (a)(4) shall, for purposes of applying such sentence, be treated as actually owned by such partner.

(5) * * *

Example 4. (i) Facts. X, a domestic corporation, and Y, a foreign corporation that is not a controlled foreign corporation, are partners in foreign partnership Z. X has a 60% interest in Z, and Y has a 40% interest in Z. All parties are calendar year taxpayers. On January 1, year 1, Z forms foreign corporation H, a controlled foreign corporation that conducts a business in Country C. On December 31, year 2, Z sells all of the H stock for \$600 when Z's adjusted basis in the stock is \$100. Therefore, Z recognizes a gain of \$500 on the sale, of which \$300 is allocable to X as a 60% partner. At the time of the sale, H had \$300 of earnings and profits, \$180 of which (i.e., 60% of \$300) is attributable to X's 60% share of the H stock.

(ii) Analysis. Pursuant to section 1248(a) and paragraphs (a)(1) and (4) of this section, X and Y are treated as selling 60% and 40%, respectively, of the H stock. X includes in its gross income as a dividend \$180 of the gain recognized on the sale. Because Y is a foreign corporation that is not a CFC, neither section 1248 nor section 964 applies to the sale of Y's 40% share of the H stock.

(iii) Alternative facts. If, instead, X owned its 60% interest in Z through another foreign partnership, the result would be the same.

* * * * *

§§1.1248-2, 1.1248-3, 1.1248-7 [Amended]

Par. 5. In §§1.1248-2, 1.1248-3, and 1.1248-7, for each entry in the “Section” column, remove the language in the “Remove” column and add the language in the “Add” column in its place.

Section	Remove	Add
§1.1248-2(a)(1)	(or was considered to be held by reason of the application of section 1223)	(or was considered to be held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-2(a)(2)(ii)	(or is considered to have held by reason of the application of section 1223)	(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-2(a)(3)	(or is considered to have held by reason of the application of section 1223)	(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-2(c)(4)	(or is considered to have held by reason of the application of section 1223)	(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

Section	Remove	Add
§1.1248-2(e)(1), introductory text	(or is considered to have held by reason of the application of section 1223)	(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-2(e)(2)	(or is considered as held by reason of the application of section 1223)	(or is considered as held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-2(e)(3)(i)	(or is considered to have held by reason of the application of section 1223)	(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-3(a)(1)	(or was considered to be held by reason of the application of section 1223)	(or was considered to be held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-3(c)(1)(ii)	(or was considered to have held by reason of the application of section 1223)	(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

Section	Remove	Add
§1.1248-3(e)(2)(i)	(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223)	(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-3(e)(3)	(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223)	(during the period such share, or block, was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-3(e)(5)	(or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223 to the person who sold or exchanged the stock)	(or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223, taking into account §1.1248-8, to the person who sold or exchanged the stock)

Section	Remove	Add
§1.1248-3(e)(6), in both locations	by reason of the application of section 1223 to such person	by reason of the application of section 1223 to such person, taking into account §1.1248-8
§1.1248-3(f)(2)(ii)	(or was considered to have held by reason of the application of section 1223)	(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-3(f)(5)(ii)	(during the period such stock was considered to be held by such person by reason of the application of section 1223)	(during the period such stock was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-3(f)(5)(iv)	(during the period such share (or block) was considered to be held by such person by reason of the application of section 1223)	(during the period such share (or block) was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248-8)

Section	Remove	Add
§1.1248-7(b)(3)(i)	(or was considered to have held by reason of the application of section 1223)	(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-7(b)(3)(iii)	(or is considered to have held by reason of the application of section 1223)	(or is considered to have held by reason of the application of section 1223, taking into account §1.1248-8)
§1.1248-7(b)(4)	(or was considered to have held by reason of the application of section 1223)	(or was considered to have held by reason of the application of section 1223, taking into account §1.1248-8)

Par. 6. Section 1.1248-8 is added to read as follows:

§1.1248-8 Earnings and profits attributable to stock following certain non-recognition transactions.

(a) Scope. This section sets forth rules for the attribution of earnings and profits for purposes of section 1248 and §1.1248-1(a)(1) and to supplement the rules in §§1.1248-2 and 1.1248-3 with respect to--

(1) Stock that an exchanging shareholder receives, or an acquiring corporation receives, in restructuring transactions. Except as otherwise provided in this paragraph (a),

stock of a foreign corporation that an exchanging shareholder receives, or an acquiring corporation receives, pursuant to a restructuring transaction (as defined in paragraph (b)(1)(vii) of this section) in which the holding period of such stock is determined by application of section 1223(1) or 1223(2), whichever is appropriate. This section shall not apply to an exchange otherwise described in this paragraph (a)(1) if, as a result of the exchange, the exchanging shareholder is required to include in income as a deemed dividend the section 1248 amount pursuant to §1.367(b)-4(b). See paragraphs (b)(2) and (3) of this section;

(2) Nonexchanging shareholders. Stock of a foreign corporation that participates in a restructuring transaction that is held by a non-exchanging shareholder (as defined in paragraph (b)(1)(vi) of this section) in the restructuring transaction. See paragraph (b)(4) of this section;

(3) Application of section 381. Stock of a foreign corporation that receives assets in a transfer to which section 361(a) applies in connection with a reorganization described in section 368(a)(1)(A), (C), (D), (F), or (G), or in a distribution to which section 332 applies, and to which section 381(c)(2)(A) and §1.381(c)(2)-1(a) apply. See paragraph (b)(6) of this section; or

(4) Section 332 liquidations. Stock of a foreign corporation that receives the assets and liabilities of a foreign corporation in a complete liquidation described in section 332 if the foreign distributee is a foreign corporate shareholder (as defined in paragraph (b)(1)(v) of this section) of the liquidating corporation. See paragraph (c) of this section.

(b) Earnings and profits attributable to stock following a restructuring transaction--

(1) Definitions. The following definitions apply for purposes of this section--

(i) Acquired corporation is a corporation whose stock or assets are acquired in exchange for stock in (or stock in and other property of) either the acquiring corporation or a foreign corporation that controls, within the meaning of section 368(c), the acquiring corporation in a restructuring transaction.

(ii) Acquiring corporation is a corporation that acquires the stock or assets of an acquired corporation in a restructuring transaction.

(iii) Controlled foreign corporation is a corporation described in section 957.

(iv) Exchanging shareholder is a person that exchanges--

(A) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 354, 356, or 361(a), stock in an acquired corporation for stock in either a foreign acquiring corporation or a foreign corporation that is in control, within the meaning of section 368(c), of an acquiring corporation (whether domestic or foreign); or

(B) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 351, property (including stock) for stock in a foreign acquiring corporation.

(v) Foreign corporate shareholder is a foreign corporation that--

(A) Owns stock of another foreign corporation; and

(B) Has a section 1248 shareholder that is also a section 1248 shareholder of the other foreign corporation.

(vi) Non-exchanging shareholder is, at the time the acquiring corporation participates in a restructuring transaction, either a section 1248 shareholder or a foreign corporate shareholder of the acquiring corporation that is not an exchanging shareholder with respect to that corporation.

(vii) Restructuring transaction is a transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 351, 354, 356, or 361.

(viii) Section 1248 shareholder is any United States person that satisfies the ownership requirements of section 1248(a)(2) and §1.1248-1(a)(2) with respect to a foreign corporation.

(2) Earnings and profits attributable to stock that an exchanging shareholder receives in a restructuring transaction. Where, in a restructuring transaction, an exchanging shareholder receives stock in a foreign corporation, the holding period of which is determined under section 1223(1), and the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately after the restructuring transaction, the earnings and profits attributable to the stock the exchanging shareholder receives shall be determined pursuant to the rules in paragraphs (b)(2)(i), (ii) and (iii) of this section.

(i) Exchanging shareholder exchanges property that is not stock of a foreign

acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder. Where the exchanging shareholder exchanges in a restructuring transaction property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder immediately before such transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall be determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7), Example 1 of this section.

(ii) Exchanging shareholder exchanges stock of a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. Except as provided in paragraph (b)(2)(iii) of this section, where the exchanging shareholder exchanges in a restructuring transaction stock of a foreign acquired corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder immediately before such restructuring transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall be the sum of the earnings and profits attributable to--

(A) The stock of the foreign acquired corporation exchanged (determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, and this section, if

applicable) that was accumulated before the restructuring transaction; and

(B) The stock of the foreign corporation that the exchanging shareholder receives in the restructuring transaction (determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, and this section, if applicable), without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction.

See paragraph (b)(7), Example 2, Example 4, and Example 6 of this section.

(iii) Exchanging shareholder receives stock in a foreign corporation that controls a domestic acquiring corporation. Where the acquiring corporation is a domestic corporation and the exchanging shareholder receives in a restructuring transaction stock in a foreign corporation that controls (within the meaning of section 368(c)) the domestic acquiring corporation, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall consist solely of the amount of earnings and profits attributable to such stock (determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, and this section, if applicable) without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7), Example 5 of this section.

(3) Earnings and profits attributable to stock in a foreign corporation certain acquiring corporations receive in a restructuring transaction. Where an acquiring corporation receives, in a restructuring transaction, stock in a foreign acquired corporation, the holding period of which is determined under section 1223(2), and the acquiring corporation is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign acquired corporation immediately after the restructuring transaction, the earnings and profits attributable to the foreign acquired corporation stock that the acquiring corporation receives shall be determined pursuant to the rules in paragraphs (b)(3)(i) and (ii) of this section.

(i) Stock of a foreign corporation with respect to which the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder. The earnings

and profits attributable to the stock of the foreign acquired corporation that the acquiring corporation receives in a restructuring transaction where the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder with respect to that foreign acquired corporation immediately before the restructuring transaction shall be determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, without regard to any portion of the section 1223(2) holding period in that stock that is prior to the restructuring transaction.

(ii) Stock of a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. The earnings and profits attributable to the stock of a foreign acquired corporation that the acquiring corporation receives in the restructuring transaction where the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately before the restructuring transaction shall be determined in accordance with §1.1248-2 or §1.1248-3, whichever is applicable, with regard to the portion of the section 1223(2) holding period of the stock that the exchanging shareholder took into account for purposes of attributing earnings and profits to that stock (determined in accordance with this section). See paragraph (b)(7), Example 3, Example 5, and Example 7 of this section.

(4) Earnings and profits attributable to stock held by a non-exchanging shareholder in a foreign acquiring corporation. (i) Except to the extent paragraph (b)(4)(ii) of this section applies, see §1.1248-2 or §1.1248-3 (whichever is applicable) and, as applicable,

paragraph (b)(6) of this section for the determination of the earnings and profits attributable to the stock held by a non-exchanging shareholder in a foreign acquiring corporation. See also paragraph (b)(7), Example 2 and Example 4 of this section.

(ii) Where a non-exchanging shareholder holds stock in a foreign corporation that is also an exchanging shareholder and a foreign acquiring corporation in the same restructuring transaction--

(A) The earnings and profits attributable to such stock shall be the sum of the earnings and profits attributable to the stock of such foreign corporation immediately before the restructuring transaction (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of the foreign acquiring corporation accumulated after the restructuring transaction (including amounts attributed under section 1248(c)(2)); and

(B) Paragraph (b)(6) of this section applies. See paragraph (b)(7), Example 8 of this section.

(iii) Where the acquiring corporation is a foreign corporate shareholder with respect to stock of a foreign acquired corporation, paragraph (b)(3) of this section shall not apply for purposes of determining the earnings and profits attributable to stock in the foreign acquiring corporation owned by a non-exchanging shareholder thereof (see section 1248(c)(2)). See paragraph (b)(7), Example 6 of this section.

(5) Reduction in earnings and profits attributable to stock to prevent multiple inclusions with respect to the same earnings and profits. To the extent consistent with the

principles of section 1248, adjustments to earnings and profits attributable to stock shall be made such that section 1223(1) and (2) and this section are applied in a manner that results in earnings and profits being taken into account only once. Thus, for example, when a controlled foreign corporation sells or exchanges all or part of the stock of another foreign corporation to which earnings and profits are attributable pursuant to this paragraph (b) or paragraph (c) of this section, proportionate reductions shall be made to the earnings and profits attributed to the stock of the selling foreign corporate shareholder owned by a section 1248 shareholder. See paragraph (b)(7), Example 7 of this section.

(6) Special rule regarding section 381. Solely for purposes of determining the earnings and profits (or deficit in earnings and profits) attributable to stock pursuant to this paragraph (b), the earnings and profits of a corporation shall not include earnings and profits that are treated as received or incurred under section 381(c)(2)(A) and §1.381(c)(2)-1(a). See paragraph (b)(7), Example 4 of this section.

(7) Examples. The application of this paragraph (b) is illustrated by the following examples. Unless otherwise indicated, in the following examples assume that--

- (i) There is no immediate gain recognition pursuant to section 367(a)(1) and the regulations under that section (either through operation of the rules or because the appropriate parties have entered into a gain recognition agreement under §§1.367(a)-3(b) and 1.367(a)-8);
- (ii) There is no income inclusion required pursuant to section 367(b) and the regulations under that section, and all reporting requirements in those regulations are

complied with;

(iii) References to earnings and profits are to earnings and profits that would be includable in income as a dividend under section 1248 and the regulations under that section if stock to which the earnings and profits are attributable were sold or exchanged by its shareholder;

(iv) Each corporation has only a single class of stock outstanding and uses the calendar year as its taxable year; and

(v) Each transaction is unrelated to all other transactions.

Example 1. A section 351 exchange of property other than stock in a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC, a foreign corporation, since CFC's formation on January 1, year 3. On December 31, year 5, DC2, a domestic corporation unrelated to DC1, contributes property it has held since January 1, year 1, to CFC in exchange for voting stock of CFC in a restructuring transaction that is an exchange under section 351. The property that DC2 contributes is not stock in a foreign corporation with respect to which DC2 was either a section 1248 shareholder or a foreign corporate shareholder. DC2 receives 80% of the voting stock of CFC in the restructuring transaction and its holding period in that CFC stock, determined pursuant to section 1223(1), began on January 1, year 1. CFC has \$100 of accumulated earnings and profits on December 31, year 5. On December 31, year 7, when the accumulated earnings and profits of CFC are \$200, DC2, a section 1248 shareholder with respect to CFC, sells its CFC stock.

(ii) Analysis. Under paragraph (b)(2)(i) of this section, the earnings and profits attributable to the CFC stock sold by DC2 are \$80. This amount consists of none of the \$100 of earnings and profits accumulated by CFC before the restructuring transaction, and 80% of the \$100 of earnings and profits of CFC accumulated after the restructuring transaction.

Example 2. A section 351 exchange of controlled foreign corporation stock by a United States person for stock in a controlled foreign corporation in a restructuring transaction. (i) Facts. The facts are the same as in Example 1 except as follows. The property that DC2 contributes is 100% of the stock in CFC2, a foreign corporation. DC2 has owned all the stock of CFC2 since CFC2's formation on January 1, year 2, and CFC2

has \$200 of earnings and profits as of December 31, year 5. CFC2 does not accumulate any additional earnings and profits from December 31, year 5, to December 31, year 7. On December 31, year 7, when the accumulated earnings and profits of CFC are \$200, DC2, a section 1248 shareholder with respect to CFC, sells its CFC stock. Also on that date, DC1 sells its CFC stock.

(ii) Analysis. (A) DC2 sale. Pursuant to paragraph (b)(2)(ii) of this section, the earnings and profits attributable to the CFC stock sold by DC2 are \$280. This amount consists of all of the \$200 of earnings and profits of CFC2 accumulated before the restructuring transaction (see also section 1248(c)(2)), none of the \$100 of earnings and profits accumulated by CFC before the restructuring transaction, and 80% of the \$100 of earnings and profits of CFC accumulated after the restructuring transaction.

(B) DC1 sale. Pursuant to paragraph (b)(4) of this section, the earnings and profits attributable to the CFC stock sold by DC1, a non-exchanging shareholder in the restructuring transaction, are \$120. This amount consists of all of the \$100 of earnings and profits of CFC accumulated before the restructuring transaction, none of the \$200 of earnings and profits of CFC2 accumulated before the restructuring transaction, and 20% of the \$100 of earnings and profits of CFC accumulated after the restructuring transaction.

Example 3. A section 351 exchange of controlled foreign corporation stock by a United States person for stock in a domestic corporation in a restructuring transaction. (i) Facts. DC1, a domestic corporation, has owned all of the stock of CFC, a foreign corporation, since CFC's formation on January 1, year 1. DC1 has also owned all the stock of DC2, a domestic corporation, since DC2's formation on January 1, year 1. On December 31, year 2, DC1 contributes the stock of CFC to DC2 in exchange for stock in DC2 in a restructuring transaction that is an exchange described in section 351. On December 31, year 2, CFC has \$100 of accumulated earnings and profits. DC2 has a basis in the CFC stock determined under section 362, and is considered to have held the CFC stock since January 1, year 1, pursuant to section 1223(2). On December 31, year 4, when the accumulated earnings and profits of CFC are still \$100, DC2 sells its CFC stock.

(ii) Analysis. Under paragraph (b)(3)(ii) of this section, \$100 of accumulated earnings and profits of CFC is attributable to the stock of CFC sold by DC2, even though DC2 did not hold the stock of CFC during the time CFC accumulated the earnings and profits.

Example 4. Acquisition of a controlled foreign corporation by a controlled foreign corporation in a reorganization described in section 368(a)(1)(C) (or section 368(a)(1)(B)). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation

unrelated to DC1, has owned all of the stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets to CFC2 in exchange for 25% of the voting stock of CFC2. CFC1 distributes the CFC2 stock to DC1 and the CFC1 stock is cancelled. DC1's holding period in the CFC2 stock, determined under section 1223(1), begins on January 1, year 1. On December 31, year 3, CFC1 has \$100 of accumulated earnings and profits and CFC2 has \$200 of accumulated earnings and profits. CFC2 succeeds to the \$100 of CFC1 accumulated earnings and profits in the reorganization under section 381. From January 1, year 4 to December 31, year 5, CFC2 incurred a deficit in earnings and profits in the amount of (\$200). On December 31, year 5, both DC1 and DC2 sell their stock in CFC2.

(ii) Analysis. (A) DC1. Pursuant to paragraph (b)(2)(ii) of this section, \$50 of earnings and profits is attributable to the CFC2 stock sold by DC1. This amount consists of \$100 of CFC1's earnings and profits accumulated before the restructuring transaction, reduced by 25% of CFC2's (\$200) post-restructuring transaction deficit in earnings and profits. None of the \$200 of CFC2's earnings and profits accumulated by CFC2 prior to the reorganization is attributed to the CFC2 stock sold by DC1. Also, none of the earnings and profits CFC2 succeeded to under section 381 is attributed to the CFC2 stock sold by DC1, pursuant to paragraph (b)(6) of this section.

(B) DC2. Pursuant to paragraph (b)(4) of this section, there is \$50 of accumulated earnings and profits attributable to the CFC2 stock sold by DC2. This amount consists of all of the \$200 of CFC2's earnings and profits accumulated by CFC2 prior to the reorganization, reduced by 75% of CFC2's deficit in earnings and profits in the amount of (\$200) incurred after the restructuring transaction. None of the \$100 of CFC1 accumulated earnings and profits succeeded to under section 381 is attributable to the CFC2 stock sold by DC2, pursuant to paragraph (b)(6) of this section.

(C) Section 368(a)(1)(B) reorganization. If, instead of DC1 acquiring its 25% interest in CFC2 pursuant to a reorganization described in section 368(a)(1)(C), DC1 had transferred the stock of CFC1 to CFC2 in exchange for 25% of the voting stock of CFC2 in a reorganization described in section 368(a)(1)(B), the results would be the same as described in paragraphs (ii) (A) and (B) of this Example 4.

Example 5. Acquisition of the stock of a foreign corporation that controls a domestic acquiring corporation in a triangular reorganization described in section 368(a)(1)(C). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of DC2, a domestic corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to DC2 in exchange for 60% of the voting stock of FC. CFC1 transferred the voting stock of FC to DC1 and the CFC1 stock was cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), DC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has \$100 of earnings and profits, CFC2 has \$300 of earnings and profits, and FC has \$200 of earnings and profits. DC1 includes the \$100 all earnings and profits amount attributable to its CFC1 stock in income as a deemed dividend under §1.367(b)-3 upon the exchange of CFC1 stock for FC stock. Pursuant to the lower tier earning exclusion of §1.367(b)-2(d)(3)(ii), that amount does not include the \$300 of earnings and profits of CFC2. From January 1, year 4, until December 31, year 5, FC

(now a controlled foreign corporation) accumulates an additional \$50 of earnings and profits. From January 1, year 4 until December 31, year 5, CFC2 accumulates an additional \$100 of earnings and profits. On December 31, year 5, DC1 sells its stock in FC and DC2 sells its stock in CFC2.

(ii) Analysis. (A) DC1. Pursuant to paragraph (b)(2)(iii) of this section, there is \$30 of earnings and profits attributable to the stock of FC sold by DC1. This amount consists of 60% of the \$50 of earnings and profits accumulated by FC after the restructuring transaction, and none of the earnings and profits accumulated by CFC1, CFC2, or FC before the restructuring transaction.

(B) DC2. Pursuant to paragraph (b)(3)(ii) of this section, there is \$400 of earnings and profits attributable to the stock of CFC2 sold by DC2. This amount consists of all of the earnings and profits accumulated by CFC2 during DC2's section 1223(2) holding period.

Example 6. Acquisition of the stock of a foreign corporation that controls a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C). (i) Facts. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of FC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to FC2 in exchange for 60% of the voting stock of FC. CFC1 transferred the voting stock of FC to DC1 and the CFC1 stock was cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), FC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has \$100 of earnings and profits, CFC2 has \$300 of earnings and profits, FC has \$200 of earnings and profits, and FC2 has no earnings and profits. From January 1, year 4, until December 31, year 5, FC (now a controlled foreign corporation) accumulates an additional \$50 of earnings and profits. From January 1, year 4 until December 31, year 5, CFC2 accumulates an additional \$100 of earnings and profits. FC2, a controlled foreign corporation after the restructuring transaction, accumulates \$100 of earnings and profits from January 1, year 4, until December 31, year 5. On December 31, year 5, DC1 sells its stock in FC.

(ii) Analysis. Pursuant to paragraphs (b)(2)(ii) and (b)(4)(iii) of this section, there is \$550 of earnings and profits attributable to the stock of FC sold by DC1. This amount consists of all \$400 of the CFC1 and CFC2 earnings and profits accumulated before the restructuring transaction (see also section 1248(c)(2)), and 60% of the \$250 of the

earnings and profits accumulated by FC, FC2, and CFC2 after the restructuring transaction.

Example 7. Acquisition of controlled foreign corporation stock by a controlled foreign corporation in a reorganization described in section 368(a)(1)(B), followed by a sale of the acquired stock by the acquiring controlled foreign corporation. (i) Facts. DC1, a domestic corporation, has owned all of the outstanding stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all of the outstanding stock of CFC3, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation unrelated to DC1, has owned all of the outstanding stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(B), CFC1 transfers all of the stock of CFC3 to CFC2 in exchange for 40% of CFC2's stock. On December 31, year 3, CFC2 and CFC3 have, respectively, \$40 and \$20 of earnings and profits. On December 31, year 5, when the accumulated earnings and profits of CFC3 are \$50 (\$20 of earnings and profits as of December 31, year 3, plus \$30 of earnings and profits generated from January 1, year 4, through December 31, year 5), CFC2 sells the stock of CFC3 in a transaction to which section 964(e) applies.

(ii) Analysis. (A) CFC2. Pursuant to paragraph (b)(3)(ii) of this section, there is \$50 of earnings and profits attributable to the CFC3 stock sold by CFC2. This amount consists of the accumulated earnings and profits attributable to CFC2's entire section 1223(2) holding period in the CFC3 stock.

(B) CFC1, DC2, and DC1. Under paragraph (b)(5) of this section, the earnings and profits attributable to the CFC2 stock held by CFC1 and DC2, and the earnings and profits attributable to the CFC1 stock held by DC1, will be reduced (regardless of whether CFC2 recognizes gain on its sale of CFC3 stock).

(1) CFC1. The earnings and profits attributable to the CFC2 stock held by CFC1 will be reduced by \$32, or the amount of earnings and profits as of December 31, year 5, that would have been attributable to the CFC2 stock held by CFC1 pursuant to paragraph (b)(2)(ii) of this section. This amount consists of all of the \$20 of earnings and profits accumulated by CFC3 before the restructuring transaction and 40% of the \$30 of earnings and profits accumulated by CFC3 after the restructuring transaction (.40 X \$30 = \$12).

(2) DC1. The earnings and profits attributable to the CFC1 stock held by DC1 will also be reduced by \$32, or the amount of earnings and profits that would have been attributable to the CFC1 stock held by DC1 as of December 31, year 5.

(3) DC2. The earnings and profits attributable to the CFC2 stock held by DC2 will be reduced by \$18, or the amount of earnings and profits that would have been attributable to the CFC2 stock held by DC2 as of December 31, year 5, under paragraph (b)(4) of this section. This amount consists of 60% of the \$30 (.60 X \$30 = \$18) of earnings and profits accumulated by CFC3 after the restructuring transaction.

(C) Partial sale by CFC2. If, instead of selling 100% of the CFC3 stock, on December 31, year 5, CFC2 sells only 50% of its CFC3 stock, paragraph (b)(5) of this section requires CFC1 to reduce the earnings and profits of CFC3 attributable to its CFC2 stock to \$16. Similarly, DC1 would be required to reduce the earnings and profits of CFC3 attributable to its CFC1 stock by \$16. Paragraph (b)(5) of this section also requires DC2 to reduce the CFC3 earnings and profits attributable to its CFC2 stock by \$9. These reductions occur without regard to whether CFC2 recognizes gain on its sale of CFC3 stock.

Example 8. Acquisition of the assets of a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation in a restructuring transaction described in section 368(a)(1)(C). (i) Facts. DC, a domestic corporation, has owned all the stock of CFC1, a controlled foreign corporation, since its formation on January 1, year 1. CFC1 is a holding company that has owned 79% of the stock of CFC2, a controlled foreign corporation, since its formation on January 1, year 1. The other 21% of CFC2 stock is owned by X, an unrelated party. On December 31, year 1, CFC2 has \$200 of earnings and profits. On December 31, year 1, CFC1 has no accumulated earnings and profits. On December 31, year 1, pursuant to a restructuring transaction described in section 368(a)(1)(C), CFC2 transfers all its properties to CFC1. In exchange, CFC1 assumes the liabilities of CFC2 and transfers to CFC2 voting stock representing 21% of the stock of CFC1. CFC2 distributes the voting stock to X and liquidates. The liabilities assumed do not exceed 20% of the value of the properties of CFC2. From January 1, year 2, to December 31, year 3, CFC1 accumulates \$100 of earnings and profits. On December 31, year 3, DC sells its CFC1 stock.

(ii) Analysis. Pursuant to paragraphs (b)(4)(ii) of this section, there is \$237 of earnings and profits attributable to DC's CFC1 stock. This amount consists of 79% of CFC2's \$200 of earnings and profits accumulated before the restructuring transaction (see section 1248(c)(2)), and 79% of CFC1's \$100 of earnings and profits accumulated after the restructuring transaction. Pursuant to paragraph (b)(6) of this section, none of CFC2's \$200 of earnings and profits to which CFC1 succeeded under section 381 would be attributable to DC's CFC1 stock.

(c) Earnings and profits attributable to stock of a foreign distributee corporation that is a foreign corporate shareholder with respect to a foreign liquidating corporation--(1)
General rule. If a foreign corporation (liquidating corporation) makes a distribution of property in complete liquidation under section 332 to a foreign corporation (distributee),

and immediately before the liquidation the distributee was a foreign corporate shareholder with respect to the liquidating foreign corporation, the amount of

earnings and profits attributable to the distributee stock, upon its subsequent sale or exchange will be determined under this paragraph (c)(1). The earnings and profits attributable will be the sum of the earnings and profits attributable to the stock of the distributee immediately before the liquidation (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of the distributee accumulated after the liquidation (including amounts attributed under section 1248(c)(2)).

(2) Special rule regarding section 381. Solely for purposes of determining the earnings and profits (or deficit in earnings and profits) attributable to stock under this paragraph (c), the attributed earnings and profits of a corporation shall not include earnings and profits that are treated as received or incurred pursuant to section 381(c)(2)(A) and §1.381(c)(2)-1(a).

(3) Example. (i) Facts. DC, a domestic corporation, has owned all of the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 is an operating company that has owned all of the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. On December 31, year 2, CFC1 has \$200 of accumulated earnings and profits and CFC2 has a (\$200) deficit in earnings and profits. On December 31, year 2, CFC2 distributes all of its assets and liabilities to CFC1 in a liquidation to which section 332 applies. From January 1, year 3, until December 31, year 4, CFC1 accumulates no additional earnings and profits. On December 31, year 4, DC sells its stock in CFC1.

(ii) Analysis. Pursuant to paragraph (c)(1) of this section, there are no earnings and profits attributable to DC's CFC1 stock. This amount consists of the sum of the earnings and profits attributable to the CFC1 stock immediately before the liquidation (100% of the \$200 accumulated earnings and profits of CFC1 and 100% of CFC2's (\$200) deficit in earnings and profits) and the amount of earnings and profits accumulated after the section 332 liquidation (see also section 1248(c)(2)).

(d) Effective date. This section applies to income inclusions that occur on or after the date these regulations are published as final regulations in the **Federal Register**.

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement