

DEPARTMENT OF THE TREASURY

Internal Revenue Service

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Stock Transfer Rules: Carryover of Earnings and Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations addressing the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a corporate reorganization or liquidation that is described in both section 367(b) and section 381 of the Internal Revenue Code (Code).

DATES: Effective Date: These regulations are effective August 8, 2006.

Applicability Date: These regulations apply to certain section 367(b) exchanges that occur on or after November 6, 2006.

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry at (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

The Treasury Department and the IRS issued final regulations ' ' 1.367(b)-1 through 1.367(b)-6, dealing with tax consequences of certain foreign-to-foreign and inbound corporate transactions, in June 1998 and January 2000 (the January 2000 final regulations). The preamble to the January 2000 final regulations referred to proposed

regulations that would be issued to address the carryover of certain corporate tax attributes in transactions involving one or more foreign corporations. Those proposed regulations were issued on November 15, 2000, in the **Federal Register** ((65 FR 69138) (REG-116050-99)) (the 2000 proposed regulations). The public hearing with respect to the 2000 proposed regulations was cancelled because no request to speak was received. However, the Treasury Department and the IRS received and considered several written comments, which are discussed in this preamble.

After consideration of the 2000 proposed regulations and the comments received, the Treasury Department and the IRS adopt substantial portions of those proposed regulations with significant modifications as final regulations under section 367(b).

## **Overview**

### A. General Policies of Section 367(b)

In general, section 367 governs corporate restructurings under sections 332, 351, 354, 355, 356, and 361 (Subchapter C nonrecognition transactions) in which the status of a foreign corporation as a "corporation" is necessary for the application of the relevant Subchapter C nonrecognition provisions. Other provisions in Subchapter C (Subchapter C carryover provisions) apply to such transactions in conjunction with the enumerated provisions and detail additional consequences that occur in connection with the transactions. For example, sections 362 and 381 govern the carryover of basis and earnings and profits from the transferor corporation to the transferee corporation in applicable transactions.

The Subchapter C carryover provisions generally are drafted to apply to domestic corporations and U.S. shareholders. As a result, those provisions often do not fully take

into account the relevant cross-border aspects of U.S. taxation. For example, section 381 does not specifically take into account source and foreign tax credit issues that arise when earnings and profits move from one corporation to another.

Congress enacted section 367(b) to ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation. A primary consideration in this regard is to prevent the avoidance of U.S. taxation. Because determining the proper interaction of the Code's international and Subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules rather than enacting a more comprehensive statutory regime. H.R. Rep. No. 658, 94th Cong., 1<sup>st</sup> Sess. 241 (1975). Thus, section 367(b)(2) provides in part that the regulations "shall include (but shall not be limited to) regulations \* \* \* providing \* \* \* the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets."

These final regulations address the carryover of foreign earnings and profits and foreign income taxes in tax-free corporate asset acquisitions by generally applying the principles of Subchapter C provisions such as section 381, which governs the carryover of earnings and profits (and other tax attributes) in certain tax-free corporate reorganizations described in section 368 and in corporate liquidations described in section 332. However, these regulations (like the 2000 proposed regulations) modify certain of the mechanics of the Subchapter C rules as necessary or appropriate to ensure that those rules are as consistent as possible with key international tax policies of the Code and to prevent material distortions of income.

These final regulations address the portions of the 2000 proposed regulations (Prop. Reg.) dealing with inbound nonrecognition transactions (Prop. Reg. §1.367(b)-3) and foreign section 381 transactions (Prop. Reg. §1.367(b)-7). They also address the special rules of Prop. Reg. §1.367-9. The final regulations, however, do not address the portions of the 2000 proposed regulations involving corporate divisions of one or more foreign corporations (Prop. Reg. §1.367(b)-8). The Treasury Department and the IRS believe that relevant cross-border tax consequences of section 355 transactions should be dealt with in a separate guidance project.

#### B. Specific Policies Related to Inbound Nonrecognition Transactions (§1.367(b)-3)

Section 1.367(b)-3 addresses acquisitions by a domestic corporation (domestic acquiring corporation) of the assets of a foreign corporation (foreign acquired corporation) in a section 332 liquidation or an asset acquisition described in section 368(a)(1), such as an A, C, D, or F reorganization (inbound nonrecognition transaction). Regulations applying section 367 and section 368 to cross-border A reorganizations were recently issued. See TD 9242 (2006-7 I.R.B. 422).

As a general policy matter, the importation of various tax attributes in inbound transactions is carefully scrutinized. In fact, inbound importation issues have been the subject of recent legislative reforms (see section 362(e)). The policy relating to importation of tax attributes also has been reflected in prior section 367 regulations. For example, the preamble to the January 2000 final regulations generally describes international policy issues that can arise in inbound nonrecognition transactions. The preamble states that the "principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic

corporations. This consideration has interrelated shareholder-level and corporate-level components." The January 2000 final regulations clarify that a domestic acquiring corporation succeeds to those foreign taxes paid or accrued by a foreign target corporation only to the extent those taxes are eligible for credit under section 906.

The preamble to the January 2000 final regulations also notes that it would be consistent with the policy considerations of section 367(b) for future regulations to provide additional rules with respect to the extent to which attributes carry over from a foreign corporation to a U.S. corporation. Accordingly, the 2000 proposed regulations provided rules concerning several attributes, specifically net operating loss and capital loss carryovers, and earnings and profits that are not included in income as an all earnings and profits amount (or a deficit in earnings and profits). The 2000 proposed regulations generally provided that these tax attributes carry over from a foreign acquired corporation to a domestic acquiring corporation only to the extent that they are effectively connected with a U.S. trade or business (or attributable to a permanent establishment, in the case of an applicable U.S. income tax treaty). These final regulations adopt the rules set forth in the 2000 proposed regulations.

### C. Specific Policies Related to Foreign Section 381 Transactions (§1.367(b)-7)

Section 1.367(b)-7 applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign section 381 transaction) and addresses the manner in which earnings and profits and foreign income taxes of the foreign acquiring corporation and foreign target corporation carry over to the surviving

foreign corporation (foreign surviving corporation). These rules apply, for example, to A, C, D, or F reorganizations or section 332 liquidations between two foreign corporations.

The principal Code sections implicated by the carryover of earnings and profits and foreign income taxes in a foreign section 381 transaction are sections 381, 902, 904, and 959. Section 381 generally permits earnings and profits (or deficit in earnings and profits) to carry over to a surviving corporation, thus enabling "the successor corporation to step into the 'tax shoes' of its predecessor. \* \* \* [and] represents the economic integration of two or more separate businesses into a unified business enterprise." H. Rep. No. 1337, 83rd Cong., 2nd Sess. 41 (1954). However, a deficit in earnings and profits of either the transferee or transferor corporation can only be used to offset earnings and profits accumulated after the date of transfer. Section 381(c)(2)(B). This is commonly known as the "hovering deficit rule". The hovering deficit rule is a legislative mechanism designed to deter the trafficking in favorable tax attributes that the IRS and courts had repeatedly encountered. See, for example, Commissioner v. Phipps, 336 U.S. 410 (1949). These final regulations generally adopt the principles of section 381 in the cross-border context, but adapt the operation of those rules in consideration of the international provisions, such as sections 902, 904, and 959, that address foreign corporations' earnings and profits and their related foreign income taxes. Thus, for example, these final regulations apply the section 381 earnings and profits combination and deficit rules by reference to the separate categories of income described in section 904(d) and elsewhere (baskets) that are used to compute foreign tax credit limitations.

Section 902 generally provides that a deemed paid foreign tax credit is available to a domestic corporation that receives a dividend from a foreign corporation in which it owns

10 percent or more of the voting stock. The Code computes deemed-paid taxes with regard to dividends from a relevant foreign corporation by looking first to the multi-year pools of earnings and profits accumulated (and related foreign income taxes paid or deemed paid) in taxable years beginning after December 31, 1986, or beginning with the first year in which a domestic corporation owns 10 percent or more of the voting stock of the foreign corporation, whichever is later. Section 902(c). (The Code and regulations refer to pooled earnings and profits and foreign income taxes as post-1986 undistributed earnings and post-1986 foreign income taxes even though a particular corporation may not begin to maintain multi-year pools until after 1986. Sections 902(c)(1) and (2), §1.902-1(a)(8) and (9).)

Congress enacted the pooling rules because it believed that blending foreign income taxes and earnings and profits into “pools” from which distributions are made was fairer and more appropriate than computing deemed-paid taxes with reference to annual layers of earnings and profits (and foreign income taxes). Joint Committee on Taxation, 99<sup>th</sup> Cong., 2<sup>nd</sup> sess., General Explanation of the Tax Reform Act of 1986 (JCS-10-87) (1986 Bluebook), at 870 (May 4, 1987). Averaging foreign income taxes through these blended pools prevents taxpayers from inflating their foreign subsidiary’s effective tax rate for a particular year in order to obtain artificially enhanced foreign tax credits. Id. Averaging also prevents the loss of credits for foreign income taxes that are trapped in years in which a foreign subsidiary has no earnings and profits for U.S. tax purposes. Id.

However, Congress enacted pooling on a limited basis. Earnings and profits accumulated (and related foreign income taxes paid or deemed paid) in taxable years before the first year a foreign corporation qualifies as a pooling corporation and pre-1987

earnings and profits accumulated (and related foreign income taxes paid or deemed paid) by a pooling corporation are not subject to the pooling rules. Rather, such earnings and profits (and related foreign income taxes) are maintained in separate annual layers. Section 902(c)(6). The Code and regulations refer to earnings and profits and foreign income taxes in annual layers as pre-1987 accumulated profits and pre-1987 foreign income taxes even though a particular corporation may have annual layers for years after 1986 (because of the absence of the requisite domestic corporate shareholder). Section 902(c)(6); §1.902-1(a)(10).

A distribution of earnings and profits is treated as first out of pooled earnings and profits and then, only after all pooled earnings and profits have been distributed, out of annual layers of earnings and profits on a LIFO basis. Section 902(a) and (c). The retention of annual layers beneath pooled earnings and profits limits the need to recreate tax histories, an administrative burden that is more significant for periods during which a corporation had limited nexus to the U.S. taxing jurisdiction and for pre-1987 earnings and profits when pooling was not required.

The foreign tax credit limitation ensures that taxpayers can use foreign tax credits only to offset U.S. tax on foreign source income. The limitation is computed separately with respect to different baskets of income derived from different types of activities. (From 1987 through 2006, section 904 provides for eight different baskets of income; for tax years beginning after December 31, 2006, all but two section 904(d) baskets of income are eliminated. Separate baskets described in other Code sections such as sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), and 904(g)(10) will continue in effect after 2006. The American Jobs Creation Act of 2004, Public Law 108-357, 118 Stat. 1418



(AJCA), section 404(a).) The purpose of the baskets is to limit taxpayers' ability to cross-credit taxes imposed with respect to different categories of income. Congress was concerned that, without separate limitations, cross-crediting opportunities would distort economic incentives as to whether to invest in the United States or abroad. 1986 Bluebook at 862.

Another international provision implicated by the movement of earnings and profits in foreign section 381 transactions is section 959. Section 959 governs the distribution of earnings and profits that represent income that has been previously taxed to U.S. shareholders under section 951(a) (PTI). After studying the interaction of section 367(b) and the PTI rules, the Treasury Department and the IRS determined that more guidance under section 959 would be useful before issuing regulations to address PTI issues that arise under section 367(b). Accordingly, the Treasury Department and the IRS have opened a separate regulations project under section 959 and expect to issue regulations that address PTI issues under section 959 in the future. Because this project is still ongoing, these final regulations reserve on section 367(b) issues related to PTI. Guidance in this area will come in a separate project.

## **Summary of Comments Received and Changes Made**

### A. Inbound Nonrecognition Transactions

A comment was received regarding the provision under the 2000 proposed regulations that limits the carryover of earnings and profits (or deficit in earnings and profits) from a foreign corporation to a domestic corporation in an inbound nonrecognition transaction to those earnings and profits that are effectively connected with the conduct of a trade or business within the United States (or are attributable to a permanent

establishment in the United States, in the context of an applicable U.S. income tax treaty).

The comment suggests that there are better ways to avoid the two most significant problems of importing foreign earnings into domestic corporate solution: potential dividends-received deductions on subsequent distribution of the previously untaxed foreign earnings, and taxing distributions of previously taxed earnings and profits described in section 959. The comment goes on to state that, in particular, eliminating deficits but taxing positive earnings on an inbound nonrecognition transaction by way of the all earnings and profits inclusion under §1.367(b)-3 is inappropriate.

The Treasury Department and the IRS have considered this comment. While the comment identifies asymmetries in the tax treatment of inbound reorganizations, on balance the Treasury Department and the IRS believe that the 2000 proposed regulations reached the appropriate result. As indicated above, the importation of favorable tax attributes has been subject to greater scrutiny in recent years. See, for example, section 362(e). In that context, it is not appropriate to provide for the carryover of deficits or of earnings and profits in excess of the all earnings and profits inclusion. This conclusion also has the benefit of administrative ease for taxpayers and the IRS. Accordingly, these final regulations do not modify the rules regarding inbound nonrecognition transactions as set forth in the 2000 proposed regulations, except to reserve on the treatment of PTI for further consideration.

#### B. Paradigm Based on Pooling rather than Look-through

The structure of the 2000 proposed regulations was based in large part on the categorization of foreign acquiring, target, and surviving corporations as look-through corporations, non-look-through corporations, or less-than-10%-U.S.-owned foreign

corporations. Under the international provisions of the Code in effect at the time the 2000 proposed regulations were published, a look-through-corporation included a controlled foreign corporation as defined in section 957 (CFC) or a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) after 2003 (a look-through 10/50 corporation), the effective date of section 1105(b) of Public Law 105-34 (111 Stat. 788) (the 1997 Act). A non-look-through corporation was a noncontrolled section 902 corporation before 2003 (non-look-through 10/50 corporation) and a less-than-10%-U.S.-owned foreign corporation was a foreign corporation that was neither a CFC nor a 10/50 corporation.

The pools of earnings and profits and foreign taxes associated with these three categories of corporations were referred to as the look-through pool, the non-look-through pool, and the pre-pooling annual layers, respectively. A number of statutory and regulatory changes that have occurred since the time the 2000 proposed regulations were published, however, have necessitated appropriate changes (and simplification) in the organizational paradigm for these final regulations.

At the time the 2000 proposed regulations were issued (and continuing prior to the AJCA), the treatment of dividends from a 10/50 corporation paid after 2002 varied according to the year in which the earnings and profits from which the dividend was paid were accumulated. The look-through approach applied to dividends paid out of earnings and profits accumulated after 2002, whereas dividends paid out of earnings and profits accumulated prior to 2003 were subject to a single separate limitation for dividends from all 10/50 corporations. Joint Committee on Taxation, 105<sup>th</sup> Cong., 1<sup>st</sup> sess., General Explanation of Tax Legislation enacted in 1997 (JCS-23-97), at 303 (December 17, 1997).

The AJCA conference report indicates that Congress changed the treatment of dividends from 10/50 corporations for purposes of simplification. H.R. Rep. No. 108-548, pt. 1 at 192 (2004).

In 2004, Congress amended the Code (the 2004 amendment) to provide that any dividend paid by a noncontrolled section 902 corporation (10/50 corporation), as defined in section 904(d)(2)(E), to a 10 percent or greater U.S. corporate shareholder is treated as income in a basket based on the ratio of the earnings and profits attributable to income in such basket to the foreign corporation's total earnings and profits (the "look-through" approach). AJCA, section 403. The 2004 amendment was effective retroactively, for taxable years beginning after December 31, 2002. Section 403(l) of the Gulf Opportunity Zone Act of 2005, Public Law 109-135 (119 Stat. 2577), permitted taxpayers to elect to defer the effective date of the 2004 amendment to taxable years beginning after December 31, 2004.

Also, as part of the 2004 amendment, dividends paid to 10% domestic corporate shareholders of a CFC are eligible for look-through treatment, even if they are paid out of earnings that were accumulated while the corporation was not a CFC. Section 904(d)(4); see also §1.904-7T(f)(3) and (6). Prior to the effective date of the 2004 amendment, dividends paid out of such earnings were subject to a separate limitation. See 26 CFR 1.904-4(g)(2)(ii) (revised as of April 1, 2006).

As a result of the 2004 amendment, the terms non-look-through 10/50 corporation and the related non-look-through pool as defined in the 2000 proposed regulations have become obsolete and therefore have been eliminated in these final regulations. More generally, in light of the broader availability of look-through treatment to earnings paid out of

pre-pooling annual layers, the Treasury Department and the IRS believe that a paradigm centered on look-through or non-look-through status is less relevant. Accordingly, the organization of these final regulations is based on the categorization of foreign acquiring, target, and surviving corporations as pooling or nonpooling corporations. The relevant pools of earnings and profits and associated foreign taxes are referred to as post-1986 pools and pre-pooling annual layers. Qualifying shareholders are eligible for look-through treatment on dividends out of post-1986 pools and pre-pooling annual layers to the extent provided in section 904(d)(3) and (4).

### C. Hovering Deficits and Section 316

Comments were received regarding the application under the 2000 proposed regulations of the hovering deficit rules on a “basket-by-basket” basis. Under the 2000 proposed regulations, a pre-transaction deficit in a particular basket is generally subject to the hovering deficit rule of section 381. As a result, that deficit is not taken into account in determining the current or accumulated earnings and profits of the surviving corporation for any purpose, including for purposes of determining dividends under section 316 and for determining foreign tax credits under section 902. However, any such pre-transaction deficits in earnings and profits may be used to offset a foreign surviving corporation's accumulated (but not current) post-transaction earnings and profits in the same basket as the deficit.

Several comments noted that, in certain circumstances, this rule can give rise to hovering deficits from one (or both) of the merging corporations even if it (or they) had aggregate positive earnings and profits immediately prior to the section 381 transaction. In addition, if one (or both) of the merging corporations' pre-transaction earnings consist

both of positive earnings in one basket and a deficit in another basket, the earnings and profits of that corporation available to support a dividend under section 316 will increase solely as a result of entering into the section 381 transaction. This is because the hovering deficit will no longer offset the positive earnings in the other basket for purposes of section 316. As a result, even if a corporation has an aggregate deficit in earnings and profits, any positive baskets of earnings will be able to support the distribution of a dividend immediately after the transaction.

The comments contend that the prohibition described above against the use of an earnings and profits deficit in one basket from offsetting positive earnings and profits in another basket can produce results that are inconsistent with the result of applying a pure section 381(c)(2)(B) approach in determining the amount of a distribution that is a "dividend" under section 316, and more generally are inconsistent with the principles and legislative history of the section 381(c)(2)(B) hovering deficit rule, which was adopted to preserve, but not create, the taxation of distributions by corporations that engage in tax-free reorganizations or liquidations.

To address these concerns, the comments requested that (among other things) the proposed regulations be modified to conform to the principles contained in Notice 88-71 (1988-2 C.B. 374), and §1.960-1(i)(4), which pro-rate an earnings and profits deficit in one basket against positive earnings and profits in other baskets for purposes of computing post-1986 undistributed earnings under section 902. It was also requested that the rules under §1.960-1(i)(4) should be modified for purposes of the hovering deficit rules to eliminate the "springing" effect of an earnings and profits deficit. Section 1.960-1(i)(4) provides that a deficit in any basket does not permanently reduce earnings in other

baskets, but after the deemed-paid taxes are computed, the deficit reverts to and is carried forward in the same basket in which it was incurred. It was asserted in the comments that once a hovering deficit is used to reduce earnings in another basket, it should not revert to its original basket in a subsequent taxable year because this deficit reincarnation results in unnecessary complexity in the calculation of earnings and profits.

The Treasury Department and the IRS have carefully considered these comments. After this consideration, they have concluded that the arguments in these comments ultimately are not persuasive. The purpose of the hovering deficit rule in the domestic context is to prevent trafficking in deficits in earnings and profits. Absent this rule, a corporation with positive earnings and profits could acquire or be acquired by another corporation with a deficit in earnings and profits and immediately reduce the amount of its positive earnings and profits, thereby reducing the amount of potentially taxable distributions.

In transactions involving foreign corporations, similar concerns exist regarding the possibility of trafficking in deficits in earnings and profits. In light of the foreign tax credit rules, unique tax benefits may arise from combining positive and deficit earnings and profits of different foreign corporations. In a reorganization involving two domestic corporations, the hovering deficit rule applies to a corporation with a net accumulated deficit in earnings and profits because the relevant statutory rules do not distinguish among classes of earnings and profits. In contrast, the foreign tax credit rules require categorization of earnings and profits according to the pooling and basket rules. Because of these distinctions, taxpayers may inappropriately benefit by trafficking in an earnings and profits deficit in a basket, pool, or particular annual layer, even though a corporation

may have net positive earnings and profits. The Treasury Department and the IRS believe that these issues merit targeted differences in the application of the hovering deficit rule in this context. Accordingly, these final regulations retain the provisions of the 2000 proposed regulations that apply the hovering deficit rule on a basket-by-basket basis.

The final regulations also include a clarification that post-transaction earnings and profits that may be offset by hovering deficits do not include earnings and profits that are distributed or deemed distributed in the same taxable year that they are earned. That is, the hovering deficit rule does not permit deficits to be offset against post-transaction earnings and profits until those earnings and profits become accumulated (as opposed to current) for tax purposes. This rule is consistent with a similar provision in the hovering deficit regulations under section 381. See §1.381(c)(2)-1(a)(5).

#### D. Hovering Deficits and Section 902

Under section 902, the amount of foreign taxes that are deemed paid by a 10% domestic corporate shareholder receiving dividends from a foreign corporation is equal to the foreign corporation's post-1986 foreign income taxes multiplied by a fraction, the numerator of which is the amount of the dividend, and the denominator of which is the foreign corporation's post-1986 undistributed earnings. Post-1986 undistributed earnings include both accumulated and current year earnings and deficits, not taking into account current year distributions. The section 902 calculation is done on a basket-by-basket basis. The 2000 proposed regulations provide that a pre-transaction deficit will only be taken into account for purposes of determining the accumulated earnings and profits of the surviving corporation in the section 902 denominator to the extent of post-transaction earnings that are accumulated in the same basket as the deficit.



A comment was made requesting that the hovering deficit rule not apply for purposes of computing deemed-paid credits under section 902, particularly in the determination of accumulated earnings and profits in the denominator of the section 902 fraction. Under this approach, the effect of the inclusion of an otherwise hovering deficit on the section 902 calculation could be beneficial or detrimental to the taxpayer, depending on the particular taxpayer's facts. For example, the suggested approach would be detrimental to taxpayers if the unrestricted use of the otherwise hovering deficit reduced the denominator of the section 902 fraction to or below zero. See §1.902-1(b)(4) (providing that no taxes are deemed paid with respect to a "nimble dividend" if post-1986 undistributed earnings are zero or less than zero). The rationale offered for this request is that it would more properly follow the intent of Congress when it amended section 902 in 1986 to average earnings and profits and foreign taxes under a pooling method.

After consideration of the comment, the Treasury Department and the IRS have concluded that it would not be appropriate to allow a pre-transaction hovering deficit from one corporation to offset pre-transaction earnings and profits of another corporation for purposes of determining the denominator of the section 902 fraction. Such an offset could increase the ratio of foreign taxes to earnings and profits in the pool and thereby in certain cases could "supercharge" the amount of foreign taxes that could be drawn out by a given distribution. The Treasury Department and the IRS believe this is not an appropriate result and could encourage taxpayers to enter into section 381 transactions to take advantage of the distortion that would result from accelerating foreign tax credits in certain cases. It is also possible that such a rule could be detrimental to taxpayers by otherwise denying them access to creditable foreign income taxes if their section 902 denominator were

eliminated. Moreover, the comment would further complicate an already complex area by mandating one set of hovering deficit treatment and calculations of earnings for section 316 and another for section 902.

An alternative request was made to the effect that, if the hovering deficit rule is retained, it should be modified to allow a pre-transaction earnings and profits deficit to offset the surviving corporation's post-transaction current year earnings and profits for purposes of determining the section 902 denominator, irrespective of whether such earnings are distributed during the taxable year.

After considering this comment, the Treasury Department and the IRS concluded that on balance it would not be appropriate to modify the proposed regulations in this manner. In many cases, allowing the hovering deficit to offset current year distributed earnings and profits for purposes of the section 902 denominator would effectively allow an offset of pre-transaction earnings and profits. This is because the opening balance of post-1986 undistributed earnings in the year following the distribution would be reduced a second time (the first reduction having occurred as a result of offsetting the current year distributed earnings and profits by the hovering deficit) as required by section 902 and the regulations thereunder to account for the distribution itself. This second reduction would reduce pre-transaction earnings and profits or, to the extent of any excess over that amount, create a deficit in accumulated earnings and profits. As described, the Treasury Department and the IRS believe that in order to minimize credit trafficking problems, pre-transaction deficits of one corporation should not be allowed to offset pre-transaction earnings of another corporation.

Additionally, implementing the modification requested in the comment would create administrative burdens for taxpayers and the IRS. If hovering deficits offset current year distributed earnings solely for purposes of section 902 but not for purposes of section 316, dual accounts would be necessary to track hovering deficits as they are separately used under each section.

Moreover, certain taxpayers would be disadvantaged under the requested modification as compared to how those taxpayers would be treated under the rule adopted in these final regulations. For example, if a foreign subsidiary has a hovering deficit in a separate basket that exceeds the sum of current plus accumulated earnings in the basket and the foreign subsidiary distributes current year post-transaction earnings in that same basket, under the requested modification, the hovering deficit would reduce the section 902 denominator to zero, with the result that no deemed-paid taxes could be claimed on the distribution. In fact, for this reason certain taxpayers have specifically requested that the hovering deficit rule apply for purposes of the section 902 fraction. Under the rules adopted by the final regulations, the hovering deficit would not reduce the section 902 denominator and therefore taxpayers would have access to deemed-paid taxes on the distribution.

#### E. Hovering Taxes

Under the 2000 proposed regulations, taxes associated with a hovering deficit do not enter into the surviving corporation's post-1986 foreign income taxes pool until the entire deficit has been offset against post-transaction accumulated earnings and profits. Comments were made requesting that the regulations be changed to provide that foreign taxes related to a hovering deficit enter the post-1986 foreign income taxes pool on a pro

rata basis as the hovering deficit to which the foreign taxes relate is used to offset post-transaction accumulated earnings and profits. The Treasury Department and IRS agree that a pro rata approach of this nature more accurately ties the availability of the foreign income taxes with the use of the related hovering deficit. Accordingly, this requested change is reflected in the final regulations.

#### F. Zipping Rule

The 2000 regulations provide that if the foreign target corporation or foreign acquiring corporation (or both) was a look-through corporation and the foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation, the post-1986 pools of earnings and profits of the look-through corporation in the separate baskets are recharacterized as a single, non-look-through pre-pooling annual layer which accumulated immediately prior to the 381 transaction (the zipping rule). In addition, the 2000 proposed regulations provide that if the foreign surviving corporation later changes to look-through status, any such recharacterized earnings and profits do not regain either their pooling or their look-through character.

A comment was made that in a case where the foreign surviving corporation subsequently changes to look-through status, if the recharacterized earnings and profits do not revert to their look-through character, a dividend paid out of those earnings would not be afforded look-through treatment. The comment argued that this would run counter to section 904(d)(2)(E)(i) which provides that look-through treatment applies to distributions by a CFC out of any earnings and profits accumulated during periods in which it was a CFC.

The Treasury Department and IRS note that this concern has been addressed by intervening statutory and regulatory changes. All distributions from a look-through corporation now receive look-through treatment, regardless of whether they are paid out of earnings and profits from post-1986 pools or pre-pooling annual layers. As a result, the concern raised in the comment is now effectively moot, and look-through treatment generally prevails. The final regulations otherwise retain the zipping rule, however, because with respect to the maintenance of pools or annual layers, this rule provides administrative advantages for both taxpayers and the IRS by not requiring subsequent U.S. shareholders of a foreign surviving corporation that continued to accumulate earnings on an annual layer basis to recreate post-1986 pools of pre-transaction earnings and profits carried over from a pooling foreign target corporation. Accordingly, the Treasury Department and the IRS decided to retain the general zipping rule provisions of the 2000 proposed regulations in these final regulations for pooling purposes, while allowing full preservation of look-through treatment.

Moreover, it should be noted that these final regulations define a pooling corporation as one that has at any time met the requirements of section 902(c)(3)(B). Accordingly, even if the foreign surviving corporation does not meet those requirements immediately after the foreign section 381 transaction, it will still be a pooling corporation if it had met those requirements at any time prior to the transaction. See §1.902-1(a)(13)(i).

#### G. Qualified and Chain Deficit Rules Under Section 952(c)(1)(B) and (C)

The section 952(c)(1)(B) subpart F qualified deficit rule and section 952(c)(1)(C) subpart F chain deficit rule allow the use of a CFC's deficit in earnings and profits to limit subpart F income inclusions for another year with respect to the stock of the same CFC or

for the same year with respect to stock of another CFC in certain cases. Under the qualified deficit rule of section 952(c)(1)(B), a prior-year earnings and profits deficit may be used to limit a qualified shareholder's current year subpart F income in the same CFC if such deficit is attributable to the same qualified activity as the activity that gives rise to the current year subpart F income. Under the chain deficit rule of section 952(c)(1)(C), a current year earnings and profits deficit may be used to limit a related corporation's current year subpart F income subject to the same qualified activity restrictions.

The 2000 proposed regulations provide that a pre-transaction deficit is not taken into account for purposes of calculating the earnings and profits limitation under the chain deficit rule. The 2000 proposed regulations are silent, however, as to the qualified deficit rule. A comment was made requesting that pre-transaction deficits be taken into account for purposes of calculating the earnings and profits limitations under both the qualified deficit rules and the chain deficit rules.

The Treasury Department and the IRS agree with this comment. The qualified deficit rule does not limit the amount of the subpart F income at the CFC level, but rather limits the amount of a particular shareholder's subpart F income inclusion under section 951(a). Because qualified deficits in earnings and profits are shareholder-level attributes and anti-trafficking provisions are already incorporated in the rules regarding qualified deficits under section 952(c)(1)(B), the Treasury Department and the IRS believe that it is appropriate to allow pre-transaction deficits to be taken into account for purposes of the calculation of qualified deficits. Though the Treasury Department and IRS believe this was already a reasonable position that could have been taken under the 2000 proposed regulations, the final regulations include a more explicit clarification of this position.

The final regulations also provide that a current year pre-transaction deficit may be taken into account for purposes of limiting subpart F income under the chain deficit rule. The Treasury Department and the IRS believe that the narrow restrictions that apply to application of the chain deficit rule are not subject to manipulation through entering into foreign section 381 transactions. Accordingly there is no policy reason for denying a qualified chain member access to a pre-transaction deficit that otherwise qualifies as a chain deficit solely because the CFC with the chain deficit engaged in a foreign section 381 transaction during the taxable year. Any such pre-transaction deficit that qualifies as a chain deficit will nonetheless remain a hovering deficit of the surviving corporation for purposes of section 316 and section 902.

#### H. Allocation of Earnings and Profits, Deficits, and Taxes During the Transaction Year

The 2000 proposed regulations include a rule that allocates the earnings and profits for the taxable year of a foreign surviving corporation in which a foreign section 381 transaction occurs as either pre-transaction earnings or post-transaction earnings on the basis of the number of days in the taxable year before and after the date of the foreign section 381 transaction. This rule parallels a similar rule found under §1.381(c)(2)-1(a)(6) and is necessary in order to determine the amount of post-transaction earnings that may be offset by hovering deficits. This rule is applied on a basket-by-basket basis for any basket in which there are positive earnings and profits for the taxable year in which the transaction occurred. No comments were received on this point, and the final regulations adopt this provision, extending it to related foreign income taxes as well.

These final regulations also contain a rule for allocating deficits, and related foreign income taxes, for the taxable year in which a foreign section 381 transaction occurs as pre-

and post-transaction deficits. If the surviving corporation has a deficit in any basket for the taxable year in which the transaction occurred, unless the actual accumulated earnings and profits, or deficit, as of the date of the transaction can be shown, the deficit shall be allocated in the same pro rata manner described above for positive earnings and profits. This rule also parallels a similar rule found under §1.381(c)(2)-1(a)(6) and is necessary in order to determine the amount of pre-transaction deficits that will hover. This rule is applied on a basket-by-basket basis for any basket in which there is a deficit in earnings and profits for the taxable year in which the transaction occurred.

The Treasury Department and the IRS believe that the addition of the allocation rule for deficits provides greater consistency with the principles and rules of section 381. It is a neutral provision and is consistent with appropriate results that could be reached under present law.

#### I. Special Rule for F Reorganizations and Similar Transactions

The 2000 proposed regulations (Prop. Reg. §1.367(b)-9) provide that the hovering deficit rules do not apply in the case of a foreign section 381 transaction that is described in section 368(a)(1)(F) or in which either the foreign target corporation or the foreign acquiring corporation is newly created. This rule was intended to prevent inappropriate tax consequences that could result from application of the hovering deficit rules to the combination of two corporations where only one of those corporations has meaningful tax attributes. For example, under the generally applicable hovering deficit rules, a foreign corporation with significant deficits in earnings and profits could combine with a newly created foreign corporation and thereafter distribute dividends (along with deemed paid



foreign income taxes under section 902), despite the presence of a significant deficit that would have precluded a dividend distribution before the transaction.

The rule under the 2000 proposed regulations addressing newly created corporations was meant to capture any transactions that are functionally equivalent to F reorganizations. However, the Treasury Department and the IRS have determined that the newly-created corporation standard under the 2000 proposed regulations is both potentially underinclusive and overinclusive in scope. It is underinclusive in that it would not apply to include foreign section 381 transactions that do not otherwise qualify as an F reorganization but that are between one foreign corporation with meaningful tax attributes and a shell corporation that is not newly created, but nevertheless has no meaningful tax attributes. In contrast, this standard is overinclusive in that it might be read to include a foreign section 381 transaction involving multiple foreign corporations with meaningful tax attributes as long as at least one party to the transaction is a newly created corporation. These transactions are neither F reorganizations nor are they functionally equivalent to F reorganizations.

Accordingly, these final regulations clarify the 2000 proposed regulations by providing that the hovering deficit rules do not apply to a foreign section 381 transaction involving at least one corporation that does not own more than a nominal amount of property or does not have more than a nominal amount of tax attributes, but no more than one corporation that does own more than a nominal amount of property or have more than a nominal amount of tax attributes. In most cases the transactions covered by this special rule will be standard F reorganizations.

#### J. Anti-abuse Rule

The 2000 proposed regulations include an anti-abuse rule that gives the Commissioner the discretion to turn off the hovering deficit rules if a principal purpose of a foreign section 381 transaction is to gain a tax benefit from affirmative use of those rules. Comments have criticized the anti-abuse rule as overly broad and inconsistent with establishing objective rules regarding the taxation of earnings distributed (or deemed distributed) by foreign subsidiaries. Moreover, the point was raised in some comments that the proposed anti-abuse rule would prevent taxpayers from relying on the existing detailed set of rules for the calculation of earnings and profits following a corporate combination in any case in which a taxpayer receives a U.S. tax benefit related to the application of the hovering deficit rule.

Upon consideration of these comments, the Treasury Department and the IRS have concluded that the anti-abuse rule in the 2000 proposed regulations should be eliminated. While the anti-abuse rule has been eliminated, the IRS will continue to examine the application of the regulations to transactions to which they apply, or potentially apply, and will be prepared to pursue issues where appropriate under the regulations and other established principles of existing law. The Treasury Department and the IRS may revisit the rules in light of experience and propose prospective changes as appropriate.

#### K. Miscellaneous

A number of conforming revisions have been made to the 2000 proposed regulations to account for relevant statutory and regulatory changes discussed above that have occurred in the intervening time period since the 2000 proposed regulations were issued. This includes the reduction of the number of baskets under section 904(d)(1), applicable for tax years beginning after December 31, 2006, as well as the fact that

distributions by look-through corporations out of annual layers accumulated during a non-look-through period are now accorded look-through treatment.

It is possible that special transition rules might be needed relating to the effect on hovering deficits in existence on the effective date of the reduction in the number of baskets under section 904(d)(1). If it is determined that such rules are necessary, they would be provided as part of a broader guidance project currently under consideration to address generally transition issues relating to the reduction in baskets.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### **Drafting Information**

The principal author of these final regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

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

Income taxes, Reporting and recordkeeping requirements.

## Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entries for §§1.367(b)-7 and 1.367(b)-9 to read in part as follows:

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

Section 1.367(b)-7 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904.

Section 1.367(b)-9 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904. \* \* \*

Par. 2. Section 1.367(b)-0 is amended by:

1. Revising the introductory text.
2. Adding entries for §1.367(b)-2(l).
3. Adding entries for §1.367(b)-3(e) and (f).
4. Adding entries for §§1.367(b)-7 through 1.367(b)-9.

The revisions and additions read as follows:

#### §1.367(b)-0 Table of contents.

This section lists the paragraphs contained in §§1.367(b)-1 through 1.367(b)-9.

\* \* \* \* \*

#### §1.367(b)-2 Definitions and special rules.

\* \* \* \* \*

- (l) Additional definitions.
- (1) Foreign income taxes.
- (2) Post-1986 undistributed earnings.
- (3) Post-1986 foreign income taxes.
- (4) Pre-1987 accumulated profits.
- (5) Pre-1987 foreign income taxes.

- (6) Pre-1987 section 960 earnings and profits.
- (7) Pre-1987 section 960 foreign income taxes.
- (8) Earnings and profits.
- (9) Pooling corporation.
- (10) Nonpooling corporation.
- (11) Separate category.
- (12) Passive category.
- (13) General category.

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

\* \* \* \* \*

- (e) Net operating loss and capital loss carryovers.
- (f) Carryover of earnings and profits.
  - (1) General rule
  - (2) Previously taxed earnings and profits. [Reserved]

\* \* \* \* \*

§1.367(b)-7 Carryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

- (a) Scope.
- (b) General rules.
  - (1) Non-previously taxed earnings and profits and related taxes.
  - (2) Previously taxed earnings and profits. [Reserved]
- (c) Ordering rule for post-transaction distributions.
  - (1) If foreign surviving corporation is a pooling corporation.
  - (2) If foreign surviving corporation is a nonpooling corporation.
- (d) Post-1986 pool.
  - (1) In general.
    - (i) Qualifying earnings and taxes.
    - (ii) Carryover rule.
  - (2) Hovering deficit.
    - (i) In general.
    - (ii) Offset rule.
    - (iii) Related taxes.
  - (3) Examples.
- (e) Pre-pooling annual layers.
  - (1) If foreign surviving corporation is a pooling corporation.
    - (i) Qualifying earnings and taxes.
    - (ii) Carryover rule.
    - (iii) Deficits.

- (A) In general.
- (B) Aggregate positive pre-1987 accumulated profits.
- (C) Aggregate deficit in pre-1987 accumulated profits.
- (D) Deficit and positive separate categories within annual layers
- (iv) Pre-1987 section 960 earnings and profits and foreign income taxes.
- (v) Examples.
- (2) If foreign surviving corporation is a nonpooling corporation.
  - (i) Qualifying earnings and taxes.
  - (ii) Carryover rule.
  - (iii) Deficits.
- (A) In general.
- (B) Aggregate positive pre-1987 accumulated profits.
- (C) Aggregate deficit in pre-1987 accumulated profits.
- (D) Deficit and positive separate categories within annual layers.
- (iv) Pre-1987 section 960 earnings and profits and foreign income taxes.
- (v) Examples.
- (f) Special rules.
  - (1) Treatment of deficit.
    - (i) General rule.
    - (ii) Exceptions.
    - (iii) Examples.
  - (2) Reconciling taxable years.
  - (3) Post-transaction change of status.
  - (4) Ordering rule for multiple hovering deficits.
    - (i) Rule.
    - (ii) Example.
  - (5) Pro rata rule for earnings and deficits during transaction year.
- (g) Effective date.

§1.367(b)-8 Allocation of earnings and profits and foreign income taxes in certain foreign corporate separations. [Reserved]

§1.367(b)-9 Special rule for F reorganizations and similar transactions.

- (a) Scope.
- (b) Hovering deficit rules inapplicable.
- (c) Foreign divisive transactions. [Reserved]
- (d) Examples.
- (e) Effective date.

\* \* \* \* \*

Par. 3. Section 1.367(b)-1 is amended by:

- 1. Removing the language “and” at the end of paragraph (c)(2)(iii).

2. Removing the period at the end of paragraph (c)(2)(iv)(B) and adding “; and” in its place.

3. Adding paragraph (c)(2)(v).

4. Revising paragraphs (c)(3)(ii)(A), (c)(4)(iv), and (c)(4)(v).

The additions and revisions read as follows:

§1.367(b)-1 Other transfers.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(v) A foreign surviving corporation described in §1.367(b)-7(a).

(3) \* \* \*

(ii) \* \* \*

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

\* \* \* \* \*

(4) \* \* \*

(iv) A statement that describes any amount (or amounts) required, under the section 367(b) regulations, to be taken into account as income or loss or as an adjustment (including an adjustment under §1.367(b)-7 or 1.367(b)-9) to basis, earnings and profits, or other tax attributes as a result of the exchange;

(v) Any information that is or would be required to be furnished with a Federal income tax return pursuant to regulations under section 332, 351, 354, 355, 356, 361, 368, or 381 (whether or not a Federal income tax return is required to be filed), if such

information has not otherwise been provided by the person filing the section 367(b) notice;

\* \* \* \* \*

Par. 4. Section 1.367(b)-2 is amended by:

1. Revising paragraph (j)(1)(i).
2. Adding paragraph (l).

The revision and addition read as follows:

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

\* \* \* \* \*

(j) Sections 985 through 989--(1) Change in functional currency of a qualified business unit--(i) Rule. If, as a result of a section 367(b) exchange described in section 381(a), a qualified business unit (as defined in section 989(a)) (QBU) has a different functional currency determined under the rules of section 985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction. A QBU that is deemed to change its functional currency pursuant to this paragraph (j) must make the adjustments described in §1.985-5.

\* \* \* \* \*

(l) Additional definitions--(1) Foreign income taxes. The term foreign income taxes has the meaning set forth in §1.902-1(a)(7).

(2) Post-1986 undistributed earnings. The term post-1986 undistributed earnings has the meaning set forth in §1.902-1(a)(9).

(3) Post-1986 foreign income taxes. The term post-1986 foreign income taxes has the meaning set forth in §1.902-1(a)(8).



(4) Pre-1987 accumulated profits. The term pre-1987 accumulated profits means the earnings and profits described in §1.902-1(a)(10)(i), computed in accordance with the rules of §1.902-1(a)(10)(ii).

(5) Pre-1987 foreign income taxes. The term pre-1987 foreign income taxes has the meaning set forth in §1.902-1(a)(10)(iii).

(6) Pre-1987 section 960 earnings and profits. The term pre-1987 section 960 earnings and profits means the earnings and profits of a foreign corporation accumulated in taxable years beginning before January 1, 1987, computed under §1.964-1(a) through (e), and translated into the functional currency (as determined under section 985) of the foreign corporation at the spot rate on the first day of the foreign corporation's first taxable year beginning after December 31, 1986. For further guidance, see Notice 88-70 (1988-2 C.B. 369, 370) (see also §601.601(d)(2) of this chapter). The term pre-1987 section 960 earnings and profits does not include earnings and profits that represent previously taxed earnings and profits described in section 959.

(7) Pre-1987 section 960 foreign income taxes. The term pre-1987 section 960 foreign income taxes means the foreign income taxes related to pre-1987 section 960 earnings and profits, determined in accordance with the principles of §1.902-1(a)(10)(iii), except that the U.S. dollar amounts of pre-1987 section 960 foreign income taxes are determined by reference to the exchange rates in effect when the taxes were paid or accrued.

(8) Earnings and profits. The term earnings and profits means post-1986 undistributed earnings, pre-1987 accumulated profits, and pre-1987 section 960 earnings and profits.

(9) Pooling corporation. The term pooling corporation means a foreign corporation with respect to which the requirements of section 902(c)(3)(B) have been met in the current taxable year or any prior taxable year.

(10) Nonpooling corporation. The term nonpooling corporation means a foreign corporation that is not a pooling corporation.

(11) Separate category. The term separate category has the meaning set forth in section 904(d)(1), and shall also include any other category of income to which section 904(a), (b), and (c) are applied separately under any other provision of the Internal Revenue Code (e.g., sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), and 904(h)(10) (or section 904(g)(10) for taxable years beginning on or before December 31, 2006).

(12) Passive category. The term passive category means the separate category that includes income described in section 904(d)(1)(A).

(13) General category. The term general category means the separate category that includes income described in section 904(d)(1)(B) (or section 904(d)(1)(I) for taxable years beginning on or before December 31, 2006).

Par. 5. Section 1.367(b)-3 is amended by adding paragraphs (e) and (f) to read as follows:

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

\* \* \* \* \*

(e) Net operating loss and capital loss carryovers. A net operating loss or capital loss carryover of the foreign acquired corporation is described in section 381(c)(1) and

(c)(3) and thus is eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation only to the extent the underlying deductions or losses were allowable under chapter 1 of subtitle A of the Internal Revenue Code. Thus, only a net operating loss or capital loss carryover that is effectively connected with the conduct of a trade or business within the United States (or that is attributable to a permanent establishment, in the context of an applicable United States income tax treaty) is eligible to be carried over under section 381. For further guidance, see Rev. Rul. 72-421 (1972-2 C.B. 166) (see also §601.601(d)(2) of this chapter).

(f) Carryover of earnings and profits--(1) General rule. Except to the extent otherwise specifically provided (see, e.g., Notice 89-79 (1989-2 C.B. 392) (see also §601.601(d)(2) of this chapter)), earnings and profits of the foreign acquired corporation that are not included in income as a deemed dividend under the section 367(b) regulations (or deficit in earnings and profits) are eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation under section 381(c)(2) only to the extent such earnings and profits (or deficit in earnings and profits) are effectively connected with the conduct of a trade or business within the United States (or are attributable to a permanent establishment in the United States, in the context of an applicable United States income tax treaty). All other earnings and profits (or deficit in earnings and profits) of the foreign acquired corporation shall not carry over to the domestic acquiring corporation and, as a result, shall be eliminated.

(2) Previously taxed earnings and profits. [Reserved]

Par. 6. In §1.367(b)-6, paragraph (a)(1) is revised to read as follows:

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

- (a) Effective date--(1) In general. Sections 1.367(b)-1 through 1.367(b)-3, and this section, apply to section 367(b) exchanges that occur on or after November 6, 2006. For guidance with respect to section 367(b) exchanges that occur prior to November 6, 2006, see §§1.367(b)-1 through 1.367(b)-6 in effect prior to November 6, 2006 (see 26 CFR part 1 revised as of April 1, 2006).

\* \* \* \* \*

Par. 7. Section 1.367(b)-7 is added to read as follows:

§1.367(b)-7 Carryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

(a) Scope. This section applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign section 381 transaction). This section describes the manner and extent to which earnings and profits and foreign income taxes of the foreign acquiring corporation and the foreign target corporation carry over to the surviving foreign corporation (foreign surviving corporation) and the ordering of distributions by the foreign surviving corporation. See §1.367(b)-9 for special rules governing reorganizations described in section 368(a)(1)(F) and foreign section 381 transactions involving foreign corporations that hold no property and have no tax attributes immediately before the transaction, other than a nominal amount of assets (and related tax attributes).

(b) General rules--(1) Non-previously taxed earnings and profits and related taxes. Earnings and profits and related foreign income taxes of the foreign acquiring corporation

and the foreign target corporation (pre-transaction earnings and pre-transaction taxes, respectively) shall carry over to the foreign surviving corporation in the manner described in paragraphs (d), (e), and (f) of this section. Dividend distributions by the foreign surviving corporation (post-transaction distributions) shall be out of earnings and profits and shall reduce related foreign income taxes in the manner described in paragraph (c) of this section.

(2) Previously taxed earnings and profits. [Reserved]

(c) Ordering rule for post-transaction distributions. Dividend distributions out of a foreign surviving corporation's earnings and profits shall be ordered in accordance with the rules of paragraph (c)(1) or (2) of this section, depending on whether the foreign surviving corporation is a pooling corporation or a nonpooling corporation.

(1) If foreign surviving corporation is a pooling corporation. In the case of a foreign surviving corporation that is a pooling corporation, post-transaction distributions shall be first out of the post-1986 pool (as described in paragraph (d) of this section) and second out of the pre-pooling annual layers (as described in paragraph (e)(1) of this section) under an annual last-in, first-out (LIFO) method.

(2) If foreign surviving corporation is a nonpooling corporation. In the case of a foreign surviving corporation that is a nonpooling corporation, post-transaction distributions shall be out of the pre-pooling annual layers (as described in paragraph (e)(2) of this section) under the LIFO method.

(d) Post-1986 pool. If the foreign surviving corporation is a pooling corporation, then the post-1986 pool shall be determined under the rules of this paragraph (d).

(1) In general--(i) Qualifying earnings and taxes. The post-1986 pool shall consist of

the post-1986 undistributed earnings and related post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) Carryover rule. Subject to paragraph (d)(2) of this section, the amounts described in paragraph (d)(1)(i) of this section attributable to the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation and shall be combined on a separate category-by-separate category basis.

(2) Hovering deficit--(i) In general. If immediately prior to the foreign section 381 transaction either the foreign acquiring corporation or the foreign target corporation has a deficit in one or more separate categories of post-1986 undistributed earnings or an aggregate deficit in pre-1987 accumulated profits, such deficit will be a hovering deficit of the foreign surviving corporation. The rules of this paragraph (d)(2) apply to hovering deficits in separate categories of post-1986 undistributed earnings. See paragraphs (e)(1)(iii) and (e)(2)(iii) of this section for rules that apply to hovering deficits in pre-1987 accumulated profits. If the foreign acquiring corporation and the foreign target corporation each have a post-1986 hovering deficit in the same separate category of post-1986 undistributed earnings, such deficits and their related post-1986 foreign income taxes shall be combined for purposes of applying this paragraph (d)(2). See also paragraphs (f)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (d)(2)).

(ii) Offset rule. A hovering deficit in a separate category of post-1986 undistributed earnings shall offset only earnings and profits accumulated by the foreign surviving corporation after the foreign section 381 transaction (post-transaction earnings) in the same separate category of post-1986 undistributed earnings. For purposes of this rule,

however, post-transaction earnings do not include post-1986 undistributed earnings in the same category that are earned after the foreign section 381 transaction, but are distributed or deemed distributed in the same year they are earned (that is, that do not become accumulated). The offset shall occur as of the first day of the foreign surviving corporation's first taxable year following the year in which the post-transaction earnings accumulated.

(iii) Related taxes. Post-1986 foreign income taxes that are related to a hovering deficit in a separate category of post-1986 undistributed earnings shall only be added to the foreign surviving corporation's post-1986 foreign income taxes in that separate category on a pro rata basis as the hovering deficit is absorbed. Pro rata means in the same proportion as the portion of the hovering deficit that offsets post-transaction earnings in the separate category under paragraph (d)(2)(ii) of this section bears to the total amount of the hovering deficit.

(3) Examples. The following examples illustrate the rules of this paragraph (d). The examples assume the following facts: foreign corporations A and B are controlled foreign corporations (CFCs) that were incorporated after December 31, 1986, have always been pooling corporations, and have always had calendar taxable years. None of the shareholders of foreign corporations A and B are required to include any amount in income under §1.367(b)-4 as a result of the foreign section 381 transaction. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, unless otherwise stated, any post-1986 undistributed earnings in the passive category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled section 902 corporation and that qualified for the subpart F same-country

exception under section 954(c)(3)(A). The examples are as follows:

Example 1. (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Foreign Corporation A</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	300u	\$60
Passive	<u>100u</u>	<u>\$40</u>
	400u	\$100

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	300u	\$70

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. Under the rules described in paragraph (d)(1) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	600u	\$130
Passive	<u>100u</u>	<u>\$40</u>
	700u	\$170

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 350u to its shareholders. Under the rules described in §1.902-1(d)(1) and paragraph (c)(1) of this section, the distribution is out of, and reduces, post-1986 undistributed earnings and post-1986 foreign income taxes in the separate categories on a pro rata basis, as follows:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	300u	\$65
Passive	<u>50u</u>	<u>\$20</u>
	350u	\$85

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following



post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	300u	\$65
Passive	<u>50u</u>	<u>\$20</u>
	350u	\$85

Example 2. (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Foreign Corporation A</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	200u	\$30
Passive	<u>(100u)</u>	<u>\$10</u>
	100u	\$40

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	300u	\$60
Passive	<u>100u</u>	<u>\$30</u>
	400u	\$90

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
General	500u		\$ 90	
Passive	<u>100u</u>	<u>(100u)</u>	<u>\$ 30</u>	<u>\$10</u>
	600u	(100u)	\$120	\$10

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 300u to its shareholders. Under the rules described in §1.902-1(d)(1) and paragraph (c)(1) of this section, the distribution is out of, and reduces, post-1986 undistributed earnings and post-1986 foreign income taxes on a pro rata basis as follows:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	250u	\$45
Passive	<u>50u</u>	<u>\$15</u>
	300u	\$60

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
General	250u		\$45	
Passive	<u>50u</u>	<u>(100u)</u>	<u>\$15</u>	<u>\$10</u>
	300u	(100u)	\$60	\$10

(iv) Post-transaction earnings--(A) In its taxable year ending on December 31, 2008, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	100u	\$20
Passive	<u>50u</u>	<u>\$10</u>
	150u	\$40

(B) None of foreign surviving corporation's earnings and profits for its 2008 taxable year qualifies as subpart F income as defined in section 952(a). Under the rules described in paragraphs (d)(2)(ii) and (iii) of this section, the hovering deficit in the passive category will offset the post-transaction earnings in that category and a proportionate amount of the foreign taxes related to the hovering deficit will be added to the post-1986 foreign income taxes pool. Because the post-transaction earnings in the passive category are half of the amount of the hovering deficit, half of the related taxes are added to the post-1986 foreign income taxes pool. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2009:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
General	350u		\$65	
Passive	<u>50u</u>	<u>(50u)</u>	<u>\$30</u>	<u>\$5</u>
	400u	(50u)	\$95	\$5

**Example 3.** (i) Facts. The facts are the same as Example 2, except that the 50u of earnings in the passive category accrued by foreign surviving corporation during 2008 is subpart F income, all of which is included in income under section 951(a) by United States shareholders (as defined in section 951(b)). This example assumes that none of the United States shareholders are able to reduce their subpart F income inclusion with a qualified deficit under section 952(c)(1)(B).

(ii) Result. (A) Under the rule described in paragraph (f)(1) of this section, the (100u) hovering deficit in the passive category does not reduce foreign surviving corporation's current passive earnings and profits for purposes of determining subpart F income or associated deemed paid credits. Thus, foreign surviving corporation's United States shareholders include their pro rata shares of 50u in taxable income for the year and are eligible for a deemed paid foreign tax credit under section 960, computed by reference to their pro rata shares of \$12.50 (50u subpart F inclusion / (50u + 50u post-1986 undistributed earnings in the passive category = 100u) = 50%, x \$25 post-1986 foreign income taxes in the passive category = \$12.50). The United States shareholders will also include their pro rata shares of the deemed-paid taxes of \$12.50 in taxable income for the year as a deemed dividend pursuant to section 78.

(B) Immediately after the subpart F inclusion and section 960 deemed paid taxes (and taking into account the taxable year 2008 earnings and profits and related taxes in the general category), foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
General	350u		\$65.00	
Passive	<u>50u</u>	<u>(100u)</u>	<u>\$12.50</u>	<u>\$10</u>
	400u	(100u)	\$77.50	\$10

(C) The 50u included as subpart F income constitutes previously taxed earnings and profits under section 959.

Example 4. (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Foreign Corporation A</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	50u	\$10
<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	(100u)	\$20

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>			<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>		Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
General	50u	(100u)	\$10	\$20	

(iii) Post-transaction earnings and distribution. (A) In its taxable year ending on December 31, 2007, foreign surviving corporation earns 100u in the general category and pays related foreign income taxes of \$24. On December 31, 2007, foreign surviving corporation distributes 75u to its shareholders.

(B) Result. For purposes of determining the dividend amount under section 316 and the foreign income taxes deemed paid with respect to that dividend under section 902, under paragraph (d)(2)(ii) of this section the hovering deficit does not offset the post-transaction current year earnings. Accordingly, the full 75u will be a dividend under section 316. The deemed paid taxes on that dividend are \$17 (75u distribution / (100u current earnings + 50u accumulated earnings) = 50%, x (\$10 accumulated foreign taxes + \$24 current year foreign taxes) = \$17). The 25u of undistributed earnings and profits in 2007 will be offset by (25u) of the hovering deficit for purposes of determining the opening balance of the post-1986 undistributed earnings pool in 2008. Because the amount of earnings offset by the hovering deficit is 25% of the amount of the hovering deficit, under paragraph (d)(2)(iii) of this section \$5 (25% of \$20) of the related taxes are added to the post-1986 foreign income taxes pool at the beginning of the next taxable year. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2008:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>			<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>		Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
General	50u	(75u)	\$22	\$15	

(e) Pre-pooling annual layers--(1) If foreign surviving corporation is a pooling corporation. If the foreign surviving corporation is a pooling corporation, the pre-pooling annual layers shall be determined under the rules of this paragraph (e)(1).

(i) Qualifying earnings and taxes. The pre-pooling annual layers shall consist of the

pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) Carryover rule. Subject to paragraph (e)(1)(iii) of this section, the amounts described in paragraph (e)(1)(i) of this section shall carry over to the foreign surviving corporation but shall not be combined. If the foreign acquiring corporation and the foreign target corporation have pre-1987 accumulated profits in the same year and a distribution is made therefrom, the rules of §1.902-1(b)(2)(ii) and (b)(3) shall apply separately to reduce pre-1987 accumulated profits and pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Rev. Rul. 68-351 (1968-2 C.B. 307); Rev. Rul. 70-373 (1970-2 C.B. 152) (see also §601.601(d)(2) of this chapter); see also paragraph (f)(2) of this section (governing the reconciliation of taxable years).

(iii) Deficit--(A) In general. The rules of this paragraph (e)(1)(iii) apply when, immediately prior to the foreign section 381 transaction, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in earnings and profits for one or more of the years that comprise its pre-1987 accumulated profits (see also paragraphs (f)(1) and (4) of this section, describing other rules applicable to a deficit described in this paragraph (e)(1)(iii)).

(B) Aggregate positive pre-1987 accumulated profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in earnings and profits for one or more years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related pre-1987 foreign income taxes of such

corporation. A deficit in pre-1987 accumulated profits for one or more years is applied to reduce pre-1987 accumulated profits on a LIFO basis. Any remaining deficit shall be applied to reduce pre-1987 accumulated profits in succeeding years. See Rev. Rul. 74-550 (1974-2 C.B. 209) (see also §601.601(d)(2) of this chapter); Champion Int'l Corp. v. Commissioner, 81 T.C. 424 (1983), acq. in result, 1987-2 C.B. 1; Rev. Rul. 87-72 (1987-2 C.B. 170) (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(C) Aggregate deficit in pre-1987 accumulated profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, a hovering deficit as defined under paragraph (d)(2)(i) of this section, then the rules under §1.902-2(b) shall apply to such hovering deficit (and related pre-1987 foreign income taxes) immediately prior to the transaction, except that the aggregate hovering deficit that is carried forward into the foreign surviving corporation's post-1986 pool shall offset only post-transaction earnings accumulated by the foreign surviving corporation in the same separate category of post-1986 undistributed earnings to which the relevant portion of the hovering deficit is attributable. Post-transaction earnings do not include earnings and profits that are earned after the foreign section 381 transaction but distributed or deemed distributed in the same year they are earned.

(D) Deficit and positive separate categories within annual layers. For purposes of applying the rules of paragraphs (e)(1)(iii)(B) and (C) of this section, if within a single pre-pooling annual layer, the foreign acquiring corporation or the foreign target corporation (or

both) has a deficit in pre-1987 accumulated profits in a separate category and positive pre-1987 accumulated profits in another separate category, the deficit shall first be used to offset the positive pre-1987 accumulated profits in the other separate category in the same pre-pooling annual layer. Any remaining deficit shall be carried forward or back to other years according to the rules of paragraph (e)(1)(iii)(B) or (C) of this section as applicable.

(iv) Pre-1987 section 960 earnings and profits and foreign income taxes. The pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. The rules otherwise applicable to such amounts shall apply separately to the pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Notice 88-70 (1988-2 C.B. 369) (see also §601.601(d)(2) of this chapter).

(v) Examples. The following examples illustrate the rules of this paragraph (e)(1). The examples assume the following facts: foreign corporation A was incorporated in 2003 and was a nonpooling corporation through December 31, 2004. Foreign corporation A became a CFC on January 1, 2005 and, as a result, began to maintain a pool of post-1986 undistributed earnings on that date. Foreign corporation B was incorporated in 2003 and has always been owned by foreign shareholders (and thus never has met the requirements of section 902(c)(3)(B)). Both foreign corporation A and foreign corporation B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a “u” functional currency. Finally, unless otherwise stated, all earnings and profits of foreign corporations A and B



are in the general category. The examples are as follows:

Example 1. (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	1,000u	\$350
2004	400u	160u
2003	<u>100u</u>	5u
	1,500u	

<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	100u	20u
2005	150u	30u
2004	0u	50u
2003	<u>50u</u>	<u>5u</u>
	300u	105u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. Under the rules described in paragraphs (e)(1)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 Pool	1,000u	\$350
2006	100u	20u
2005	150u	30u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	<u>50u</u>	5u
	1,800u	

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,725u to its shareholders. Under the rules of paragraph (c)(1) of this section, the distribution is first out of the post-1986 pool, and then out of the pre-pooling annual layers under the LIFO method, as follows:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	1,000u	\$350
2006	100u	20u
2005	150u	30u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1	400u	160u
2004 layer #2	0u	0u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1	50u	2.5u
	(100u in layer / 150u aggregate 2003 earnings = 66.67% x 75u distribution)	
2003 layer #2	25u	2.5u
	(50u in layer / 150u aggregate 2003 earnings = 33.33% x 75u distribution)	
	<u>1,725u</u>	

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2004 layer #2	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1	50u	2.5u
2003 layer #2	<u>25u</u>	<u>2.5u</u>
	75u	55u

(iv) Post-transaction earnings. For the taxable year ending on December 31, 2008, foreign surviving corporation has 500u of current earnings and profits in the general category, none of which qualify as subpart F income under section 952(a), and pays \$70 in foreign income taxes. As of the close of the 2008 taxable year, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	500u	\$70
2004	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1	50u	2.5u
2003 layer #2	<u>25u</u>	2.5u
	575u	

Example 2. (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	1,000u	\$350
2004	100u	20u
2003	<u>(50u)</u>	5u
	1,050u	

<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	100u	20u
2005	(50u)	5u
2004	0u	50u
2003	<u>100u</u>	<u>10u</u>
	150u	85u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. Because foreign corporations A and B have aggregate positive amounts of pre-1987 accumulated profits with a deficit in one or more years, the rules of paragraph (e)(1)(iii)(B) of this section apply. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Deficit E&amp;P</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with <u>Deficit E&amp;P</u>
Post-1986 pool	1,000u		\$350	
2006	100u		20u	
2005		(50u)		5u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>				
2004 layer #1 (from Corp A)	100u		20u	
2004 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>				
2003 layer #1 (from Corp A)		(50u)		5u
2003 layer #2 (from Corp B)	<u>100u</u>		10u	
	1,300u	<u>(100u)</u>		<u>10u</u>

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,175u to its shareholders. Under the rules described in paragraphs (c)(1) and (e)(1)(iii)(B) of this section, the distribution is first out of the post-1986 pool, and then out of the pre-pooling annual layers, as follows:

<u>Distribution</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	1,000u	\$350
2006	100u	20u
2005	0u	0u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1	50u	20u
2004 layer #2	0u	0u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1	0u	0u
2003 layer #2	<u>25u</u>	5u
	1,175u	

(B) Under paragraph (e)(1)(iii)(B) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more years, apply separately to the pre-1987 accumulated profits and related foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 50u can be distributed from foreign corporation A's pre-pooling annual layers and is out of its 2004 layer #1 (after rolling forward the (50u) deficit in 2003 layer #1 to reduce earnings in 2004 layer #1 to 50u (100u - 50u)). Under the principles of §1.902-1(b)(3), the full 20u of taxes related to 2004 layer #1 is reduced or deemed paid ( $\$20 \times (50/50)$ ). 100u is distributed from foreign corporation B's 2006 annual layer. Foreign corporation B's (50u) deficit in 2005 is then rolled back to offset its 2003 annual layer to reduce earnings in that layer to 50u, 25u of which is distributed. Thus, after the distribution, 25u remains in 2003 layer # 2 along with 5u of foreign income taxes ( $10u \times (25u / 50u)$ ).

(C) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(D) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2005	0u	5u
2004 layer #2	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1	0u	5u
2003 layer #2	<u>25u</u>	<u>5u</u>
	25u	65u

(E) Under paragraph (e)(1)(iii)(B) of this section, the 5u, 50u, and 5u of pre-1987 foreign income taxes related to foreign surviving corporation's 2005 layer, 2004 layer #2, and 2003 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902-2(b)(2).

Example 3. (i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	1,000u	\$350
2004	150u	20u
2003	<u>100u</u>	5u
	1,250u	

<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	100u	20u
2005	(250u)	5u
2004	0u	50u
2003	<u>100u</u>	<u>10u</u>
	(50u)	85u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. (A) Because foreign corporation B has an aggregate hovering deficit in pre-1987 accumulated profits, the rules of paragraph (e)(1)(iii)(C) of this section apply. Accordingly, §1.902-2(b) applies immediately prior to the foreign section 381 transaction, except that the hovering deficit is carried forward into the foreign surviving corporation's post-1986 undistributed earnings pool and will offset only post-transaction earnings accumulated by foreign surviving corporation in the general category. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
Post-1986 pool	1,000u	(50u)	\$350	\$0
2006	0u		20u	
2005	0u		5u	
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>				
2004 layer #1 (from Corp A)	150u		20u	
2004 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>				
2003 layer #1 (from Corp A)	100u		5u	
2003 layer #2 (from Corp B)	0u		10u	
	<u>1,250u</u>	<u>(50u)</u>		<u>\$0</u>

(B) Under paragraph (e)(1)(iii)(C) of this section, the 20u, 5u, 50u, and 10u of pre-1987 foreign income taxes associated with foreign corporation B's pre-1987 accumulated profits for 2006, 2005, 2004 layer #2, and 2003 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902-2(b)(2).

(2) If foreign surviving corporation is a nonpooling corporation. If the foreign surviving corporation is a nonpooling corporation, then the pre-pooling annual layers shall be determined under the rules of this paragraph (e)(2).

(i) Qualifying earnings and taxes. The pre-pooling annual layers shall consist of the pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation. If the foreign acquiring corporation or the foreign target corporation (or both) has post-1986 undistributed earnings

or a deficit in post-1986 undistributed earnings, then those earnings or deficits and any related post-1986 foreign income taxes shall be recharacterized as pre-1987 accumulated profits or deficits and pre-1987 foreign income taxes of the foreign acquiring corporation or the foreign target corporation accumulated immediately prior to the foreign section 381 transaction.

(ii) Carryover rule. Subject to paragraph (e)(2)(iii) of this section, the amounts described in paragraph (e)(2)(i) of this section shall carry over to the foreign surviving corporation but shall not be combined. If the foreign acquiring corporation and the foreign target corporation have pre-1987 accumulated profits in the same year and a distribution is made therefrom, the principles of §1.902-1(b)(2)(ii) and (3) shall apply separately to reduce pre-1987 accumulated profits and pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Rev. Rul. 68-351 (1968-2 C.B. 307); Rev. Rul. 70-373 (1970-2 C.B. 152) (see also §601.601(d)(2) of this chapter); see also paragraph (f)(2) of this section (governing the reconciliation of taxable years).

(iii) Deficits--(A) In general. The rules of this paragraph (e)(2)(iii) apply when, immediately prior to the foreign section 381 transaction (and after application of the last sentence of paragraph (e)(2)(i) of this section), the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in one or more years that comprise its pre-1987 accumulated profits. See also paragraphs (f)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (e)(2)(iii)).

(B) Aggregate positive pre-1987 accumulated profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero)



amount of pre-1987 accumulated profits, but a deficit in pre-1987 accumulated profits in one or more years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related foreign income taxes of such corporation. A deficit in pre-1987 accumulated profits for one or more years is applied to reduce pre-1987 accumulated profits on a LIFO basis. Any remaining deficit shall be applied to reduce pre-1987 accumulated profits in succeeding years. See Rev. Rul. 74-550 (1974-2 C.B. 209) (see also §601.601(d)(2) of this chapter); Champion Int'l Corp. v. Commissioner, 81 T.C. 424 (1983), acq. in result, 1987-2 C.B. 1; Rev. Rul. 87-72 (1987-2 C.B. 170) (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(C) Aggregate deficit in pre-1987 accumulated profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, a hovering deficit as defined under paragraph (d)(2)(i) of this section, then the rules otherwise applicable to such hovering deficits shall apply separately to the pre-transaction earnings and profits and related taxes of the relevant corporation. See, e.g., sections 316(a) and 381(c)(2)(B). Thus, any hovering deficit shall offset only post-transaction earnings accumulated by the foreign surviving corporation in the same separate category of earnings and profits to which the relevant portion of the hovering deficit is attributable. Post-transaction earnings do not include earnings and profits that are earned after the foreign section 381 transaction but distributed or deemed distributed in the same year they are earned. Following the principles of §1.902-2(b), if there is an

aggregate deficit in pre-1987 accumulated profits, any related pre-1987 foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and creates a pre-transaction aggregate positive balance for pre-1987 accumulated profits.

(D) Deficit and positive separate categories within annual layers. For purposes of applying the rules of paragraphs (e)(2)(iii)(B) and (C) of this section, if within a single pre-pooling annual layer, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in pre-1987 accumulated profits in a separate category and positive pre-1987 accumulated profits in another separate category, the deficit shall first be used to offset the positive pre-1987 accumulated profits in the other separate category in the same pre-pooling annual layer. Any remaining deficit shall be carried forward or back to other years according to the rules of paragraph (e)(2)(iii)(B) or (C) as applicable.

(iv) Pre-1987 section 960 earnings and profits and foreign income taxes. The pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. The rules otherwise applicable to such amounts shall apply separately to the pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a pro rata basis. For further guidance, see Notice 88-70 (1988-2 C.B. 369) (see also §601.601(d)(2) of this chapter).

(v) Examples. The following examples illustrate the rules of this paragraph (e)(2). The examples assume the following facts: both foreign corporation A and foreign corporation B have always had calendar taxable years. Foreign corporations A and B (and

all of their respective qualified business units as defined in section 989) maintain a “u” functional currency, and 1u = US\$1 at all times. Finally, unless otherwise stated, all earnings and profits of foreign corporations A and B are in the general category. The examples are as follows:

Example 1. (i) Facts. (A) Foreign corporations A and B both were incorporated in 2003. Nine percent of the voting stock of foreign corporation A is owned by domestic corporate shareholder C. Nine percent of the voting stock of foreign corporation B is owned by domestic corporate shareholder D. Shareholders C and D are unrelated. The remaining 91% of the voting stock of each foreign corporation is owned by unrelated foreign shareholders. Thus, neither corporation meets the requirements of section 902(c)(3)(B). On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	500u	350u
2005	400u	300u
2004	400u	160u
2003	<u>100u</u>	<u>5u</u>
	1,400u	815u

<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	100u	20u
2005	300u	60u
2004	0u	50u
2003	<u>50u</u>	<u>5u</u>
	450u	135u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) Result. Under the rules described in paragraphs (e)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>		
2006 layer #1 (from Corp A)	500u	350u
2006 layer #2 (from Corp B)	100u	20u
<u>Two Side-by-Side Layers of 2005 E&amp;P:</u>		
2005 layer #1 (from Corp A)	400u	300u
2005 layer #2 (from Corp B)	300u	60u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	<u>50u</u>	<u>5u</u>
	1,850u	950u

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 600u to its shareholders. Under the rules of paragraph (c)(3) of this section, the distribution is out of pre-pooling annual layers under the LIFO method as follows:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>		
2006 layer #1 (from Corp A)	500u	350u
2006 layer #2 (from Corp B)	<u>100u</u>	<u>20u</u>
	600u	370u

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim deemed paid foreign income taxes under section 902. See §1.902-1(a)(10)(iii).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

<u>E&amp;P</u>	<u>Foreign Taxes</u>
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<u>Two Side-by-Side Layers of 2005 E&amp;P:</u>		
2005 layer #1 (from Corp A)	400u	300u
2005 layer #2 (from Corp B)	300u	60u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	<u>50u</u>	<u>5u</u>
	1,250u	580u

Example 2. (i) Facts. (A) The facts are the same as in Example 1 (i)(A), except that foreign corporation A met the requirements of section 902(c)(3)(B) on January 1, 2005, when U.S. corporate shareholder C acquired an additional 1% of voting stock for a total ownership interest of 10%; foreign corporation A thereby became a pooling corporation. On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	900u	\$650
2004	400u	160u
2003	<u>100u</u>	5u
	1,400u	

<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	100u	20u
2005	300u	60u
2004	0u	50u
2003	<u>50u</u>	<u>5u</u>
	450u	135u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) Result. Under the rules described in paragraphs (e)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>		
2006 layer #1 (from Corp A's pool)	900u	\$650
2006 layer #2 (from Corp B's layer)	100u	20u
2005 (from Corp B):	300u	60u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	<u>50u</u>	5u
	1,850u	

(iii) Subsequent ownership change. On July 1, 2010, USS (a domestic corporation) acquires 100% of the stock of foreign surviving corporation. Under the rules of paragraph (f)(3) of this section, foreign surviving corporation begins to pool its earnings and profits under section 902(c)(3) as of January 1, 2010. Foreign surviving corporation's earnings and profits and foreign income taxes accrued before January 1, 2010 retain their character as pre-1987 accumulated profits and pre-1987 foreign income taxes.

Example 3. (i) Facts. (A) The facts are the same as in Example 2 (i)(A), except that on December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	1,000u	\$500
2004	(200u)	10u
2003	<u>400u</u>	5u
	1,200u	
<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	300u	20u
2005	(100u)	60u
2004	0u	50u
2003	<u>50u</u>	<u>5u</u>
	250u	135u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) Result. Because foreign corporations A and B have aggregate positive amounts of pre-1987 accumulated profits with a deficit in one or more years, the rules of paragraph (e)(2)(iii)(B) of this section apply. Accordingly, after the foreign section 381 transaction,

foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Deficit E&amp;P</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Deficit E&amp;P</u>
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>				
2006 layer #1 (from Corp A's pool)	1,000u		\$500	
2006 layer #2 (from Corp B's layer)	300u		20u	
2005 (from Corp B)		(100u)		60u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>				
2004 layer #1 (from Corp A)		(200u)		10u
2004 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>				
2003 layer #1 (from Corp A)	400u		5u	
2003 layer #2 (from Corp B)	<u>50u</u>		5u	
	1,750u	<u>(300u)</u>		<u>70u</u>

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,300u to its shareholders. Under the rules described in paragraphs (c)(3) and (e)(2)(iii)(B) of this section, the distribution is out of the pre-pooling annual layers, as follows:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>		
2006 layer #1	1,000u	\$500
2006 layer #2	250u	20u
<u>2003 E&amp;P:</u>		
2003 layer #1	50u	1.25u (25% of 5u taxes)
	<hr/> 1,300u	

(B) Under paragraph (e)(2)(iii)(B) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more years, apply separately to the pre-1987 accumulated profits and related pre-1987 foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 1,200u and 250u can be distributed out of foreign corporation A's and foreign corporation B's pre-pooling annual layers, respectively. Thus, 1,000u of the distribution is out of foreign corporation A's 2006 layer #1 and 250u is out of foreign corporation B's 2006 layer #2. (after rolling forward (50u) of the deficit in 2005 layer to reduce earnings in 2006 layer #1 to 250u (300u - 50u)) Under the principles of §1.902-1(b)(3), all of the taxes in each of those respective layers are reduced. The remaining 50u is distributed from foreign corporation A's 2003 layer #1 (after rolling back the (200u) deficit in 2004 layer #1 to reduce earnings in 2003 layer #1 to 200u (400u - 200u)). Thus, after the distribution, 150u remains in the 2003 layer #1 along with 3.75u of foreign income taxes (5u x (150u / 200u)).

(C) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim a credit for deemed paid foreign income taxes under section 902. See §1.902-1(a)(10)(iii).

(D) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:



	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2005	0u	60u
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>		
2004 layer #1	0u	10u
2004 layer #2	0u	50u
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>		
2003 layer #1	150u	3.75u
2003 layer #2	<u>0u</u>	<u>5u</u>
	150u	128.75u

(E) Under paragraph (e)(2)(iii)(B) of this section, the 60u, 10u, 50u, and 5u of foreign income taxes related to foreign surviving corporation's 2005 layer, 2004 layer #1, 2004 layer #2, and 2003 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902-2(b)(2).

Example 4. (i) Facts. (A) The facts are the same as in Example 2 (i)(A), except that on December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Post-1986 pool	(1,000u)	\$20
2004	(200u)	10u
2003	<u>400u</u>	5u
	(800u)	
<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	100u	20u
2005	300u	60u
2004	0u	50u
2003	<u>50u</u>	<u>5u</u>
	450u	135u

(B) On January 1, 2007, foreign corporation A acquires the assets of foreign corporation B in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation.

(ii) Result. (A) Under paragraph (e)(2)(i) of this section, foreign corporation A's post-1986 pool is recharacterized as a 2006 layer of pre-1987 accumulated profits. Because after the foreign section 381 transaction foreign corporation A has an aggregate deficit in pre-1987 accumulated profits, the rules of paragraph (e)(2)(iii)(C) of this section apply and the rules otherwise applicable apply separately to the pre-1987 accumulated profits that carry over to foreign surviving corporation from foreign corporation A. The

(800u) aggregate deficit in foreign corporation A's pre-1987 accumulated profits is a hovering deficit that will offset only post-transaction earnings accumulated by foreign surviving corporation in the general category. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Deficit E&amp;P</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Deficit E&amp;P</u>
Hovering deficit from Corp A's annual layers		(800u)		0
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>				
2006 layer #1 (from Corp A's pool)		0u		\$20
2006 layer #2 (from Corp B's layer)	100u		20u	
2005 (from Corp B)	300u		60u	
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>				
2004 layer #1 (from Corp A)		0u		10u
2004 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>				
2003 layer #1 (from Corp A)	0u		5u	
2003 layer #2 (from Corp B)	<u>50u</u>		<u>5u</u>	
	450u	<u>(800u)</u>	140u	

(B) Under paragraph (e)(2)(iii)(C) of this section, the \$20, 10u, and 5u of pre-1987 foreign income taxes associated with foreign corporation A's pre-1987 accumulated profits for 2006 layer #1, 2004 layer #1, and 2003 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902-2(b)(2).

(iii) Post-transaction distribution. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 200u to its shareholders. Under the rules described in paragraph (e)(2)(iii)(C) of this section, no distribution can be made out of the pre-1987 accumulated profits of foreign corporation A (and the (800u) aggregate hovering deficit will offset only post-transaction earnings accumulated by foreign surviving corporation). Thus, the distribution is out of pre-pooling annual layers as follows:

	<u>E&amp;P</u>	<u>Foreign Taxes Paid</u>
2006 layer #2	100u	20u
2005	100u	20u
	200u	40u

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim deemed paid foreign income taxes under section 902. See §1.902-1(a)(10)(iii).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Deficit E&amp;P</u>	<u>Taxes Available</u>	<u>Foreign Taxes Associated with Deficit E&amp;P</u>
Hovering deficit From Corp A's annual layers		(800u)		0
<u>Two Side-by-Side Layers of 2006 E&amp;P:</u>				
2006 layer #1 (from Corp A's pool)		0u		\$20
2006 layer #2 (from Corp B's layer)	0u		0u	
2005 (from Corp B)	200u		40u	
<u>Two Side-by-Side Layers of 2004 E&amp;P:</u>				
2004 layer #1 (from Corp A)		0u		10u
2004 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 2003 E&amp;P:</u>				
2003 layer #1 (from Corp A)	0u		5u	
2003 layer #2 (from Corp B)	<u>50u</u>		<u>5u</u>	
	250u	<u>(800u)</u>	140u	

(f) Special rules--(1) Treatment of deficit--(i) General rule. Any deficit described in paragraph (d)(2), (e)(1)(iii), or (e)(2)(iii) of this section shall not be taken into account in determining current or accumulated earnings and profits of a foreign surviving corporation other than to offset post-transaction accumulated earnings, as defined in paragraph (d)(2)(ii) of this section, including for purposes of calculating--

(A) The earnings and profits limitation of section 952(c)(1)(A); and

(B) The amount of the foreign surviving corporation's subpart F income as defined in section 952(a).

(ii) Exceptions. The rule in paragraph (i) shall not apply for purposes of calculating an earnings and profits limitation under section 952(c)(1)(B) or (C).

(iii) Examples. The following examples illustrate the principles of this paragraph (f)(1). The examples assume the following facts: foreign corporation A, incorporated in 2002, is and always has been a wholly owned subsidiary of USP, a domestic corporation. Foreign corporation B, incorporated in 2004, is and always has been a wholly owned subsidiary of foreign corporation A. Both foreign corporation A and foreign corporation B are organized under the laws of foreign country X and have always had a calendar taxable year. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Unless otherwise stated, any earnings and profits or deficit in earnings and profits of foreign corporation A and B in the general category are attributable to subpart F income derived from foreign base company sales income. Foreign corporation C is a wholly owned subsidiary of USP2 and was organized in 2004 under the laws of foreign country Y. Foreign corporation C (and all of its qualified business units as defined in section 989) maintains a "u" functional currency. Earnings and profits of foreign corporation C in the general category are not attributable to subpart F income. The examples are as follows:

Example 1. (i) Facts. (A) On December 31, 2007, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Foreign Corporation A</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	(100u)	\$25

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	0u	\$10

(B) On January 1, 2008, foreign corporation B elects under §301.7701-3(c) of this chapter to be disregarded as an entity separate from foreign corporation A. Accordingly, foreign corporation B is deemed to have distributed all its property to foreign corporation A in a liquidation described in section 332.

(ii) Result. Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
General	0u	(100u)	\$10	\$25

(iii) Post-transaction earnings and subpart F limitations. (A) In its taxable year ending on December 31, 2008, foreign surviving corporation A earns 300u of subpart F general category income with respect to which it pays \$50 in foreign income taxes. The hovering deficit of (100u) meets the requirements under section 952(c)(1)(B) and therefore is taken into account as a qualified deficit that may be used by USP to offset a portion of its income inclusion related to foreign surviving corporation A's subpart F income of 300u in the 2008 taxable year. Accordingly, USP includes 200u in taxable income for the year and is eligible for a deemed paid foreign tax credit under section 960 of \$40 (200u subpart F inclusion / 300 post-1986 undistributed earnings in the general category = 66.67%, x \$60 foreign income taxes in the general category = \$40). USP will also include the deemed paid foreign taxes of \$40 in taxable income for the year as a deemed dividend pursuant to section 78. Though the (100u) hovering deficit of foreign surviving corporation A is taken into account for purposes of limiting USP's subpart F income inclusion under section 952(c)(1)(B), the amount of the hovering deficit is not reduced for purposes of sections 316 and 902 and none of the associated foreign income taxes are included in the post-1986 foreign income taxes pool.

(B) As of January 1, 2009, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
General	100u	(100u)	\$ 20	\$25

(C) The 200u included as subpart F income constitutes previously taxed earnings under section 959.

Example 2. (i) Facts. (A) On July 1, 2007, foreign corporation B elects under §301.7701-3(c) of this chapter to be disregarded as an entity separate from foreign corporation A. Accordingly, foreign corporation B is deemed to have distributed all of its property to foreign corporation A in a liquidation described in section 332.

(B) Neither foreign corporation A nor B has any post-1986 undistributed earnings or post-1986 foreign income taxes as of the beginning of the 2007 taxable year. For its short taxable year ending on June 30, 2007, foreign corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	(200u)	\$30

(C) For the 2007 taxable year, foreign surviving corporation A earns a total of 200u of subpart F foreign based company sales income in the general category with respect to which it pays \$40 in foreign income taxes.

(ii) Result. (A) Under paragraph (d)(2) of this section, foreign corporation B's (200u) deficit carries over to foreign surviving corporation A as a hovering deficit. Nevertheless, because it is a deficit of a qualified chain member for a taxable year ending within the 2007 taxable year of foreign surviving corporation A, the (200u) deficit meets the requirements under section 952(c)(1)(C) and therefore may still be taken into account for purposes of limiting foreign surviving corporation A's subpart F income. Accordingly, foreign surviving corporation A's 200u of subpart F income for the 2007 taxable year is fully offset by the (200u) deficit of foreign corporation B, and USP will have no subpart F income inclusion for the 2007 taxable year. The offset under section 952(c)(1)(C) does not result in a reduction of the hovering deficit for purposes of section 316 or section 902. The hovering deficit may not also be taken into account under section 952(c)(1)(B).

(B) Because USP has no subpart F income inclusion, foreign surviving corporation A's subpart F earnings of 200u will accumulate and be added to its post-1986 undistributed earnings as of the beginning of 2008. Under the rules of paragraph (f)(5) of this section, a pro rata amount, in this case 50% or 100u, will be deemed to have been



accumulated prior to the foreign section 381 transaction and the other 50%, or 100u, will be deemed to have been accumulated after the foreign section 381 transaction. The 100u of post-transaction earnings will be offset by (100u) of the hovering deficit for purposes of determining the opening balance of the post-1986 undistributed earnings pool in 2008. Because the amount of earnings offset by the hovering deficit is 50% of the total amount of the hovering deficit, \$15 (50% of \$30) of the related taxes are added to the post-1986 foreign income taxes pool as well. The 100u of pre-transaction earnings remain in the post-1986 undistributed earnings pool. Accordingly, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2008:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
General	100u	(100u)	\$ 55	\$15

Example 3. (i) Facts. (A) On January 1, 2007, foreign corporation B and foreign corporation C have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	(100u)	\$0

<u>Foreign Corporation C</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
General	0u	\$10

(B) On July 1, 2007, foreign corporation B acquires the assets of foreign corporation C in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation B is a CFC.

(C) During the 2007 taxable year foreign surviving corporation B has a current deficit of (400u) and \$60 of related foreign income taxes. During its short taxable year ending on June 30, 2007, foreign corporation C has no additional earnings and pays or accrues no foreign income taxes.

(ii) Result. (A) Under the rules of paragraph (f)(5) of this section, a pro rata amount, in this case 50% or (200u), of foreign surviving corporation B's (400u) current year deficit for the 2007 taxable year will be deemed to have been accumulated prior to the foreign section 381 transaction and be treated as a hovering deficit. The other 50%, or (200u) of

the deficit will be deemed to have been accumulated after the foreign section 381 transaction. The related foreign income taxes of \$60 will also be allocated on a similar 50/50 basis.

(B) Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes as of January 1, 2008:

<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
General	(200u)	(300u)	\$ 40	\$30

(iii) Subpart F income limitations. Even though (200u) of the current year deficit is treated as a hovering deficit, the full (400u) current year deficit in 2007 of foreign surviving corporation B meets the requirements under section 952(c)(1)(C) and therefore is available as a limitation on subpart F income, to the extent foreign corporation A, which wholly owns foreign surviving corporation B, earns any subpart F income in the 2007 taxable year. Any such offset under section 952(c)(1)(C) will have no effect on the earnings and profits and foreign income tax accounts above of foreign surviving corporation B for purposes of sections 316 and 902. Moreover, to the extent the hovering deficit reduces subpart F income under section 952(c)(1)(C), it may not also be taken into account under section 952(c)(1)(B).

(2) Reconciling taxable years. If a foreign acquiring corporation and a foreign target corporation had taxable years ending on different dates, then the pro rata distribution rules of paragraphs (e)(1)(ii) and (e)(2)(ii) of this section shall apply with respect to the taxable years that end within the same calendar year.

(3) Post-transaction change of status. If a foreign surviving corporation that is subject to the rules of paragraph (c)(2) of this section subsequently becomes a pooling corporation (by reason, for example, of a reorganization, liquidation, or change of ownership), then post-1986 undistributed earnings and post-1986 foreign income taxes that were recharacterized as pre-1987 accumulated profits and pre-1987 foreign income

taxes, respectively, under paragraph (e)(2)(i) of this section retain their characterization as a pre-pooling annual layer.

(4) Ordering rule for multiple hovering deficits--(i) Rule. A foreign surviving corporation shall apply the deficit rules of paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section in that order if more than one of such rules applies to the foreign surviving corporation.

(ii) Example. The following example illustrates the principles of this paragraph (f)(4). The example assumes the following facts: foreign corporation A has been a pooling corporation since its incorporation on January 1, 1998. Foreign corporation B has been a nonpooling corporation since its incorporation on January 1, 2000. Foreign corporations A and B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a “u” functional currency. All earnings and profits of foreign corporation B are in the general category. Finally, unless otherwise stated, any earnings and profits in the passive category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled section 902 corporation and that qualified for the subpart F same-country exception under section 954(c)(3)(A). The example is as follows:

Example--(i) Facts. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

<u>Foreign Corporation A</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
<u>Post-1986 Pool Separate Category:</u>		
Passive	400u	\$160
General	(300u)	\$ 25
	100u	\$185

<u>Foreign Corporation B</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
2006	(300u)	50u
2005	<u>100u</u>	<u>25u</u>
	(200u)	75u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) Result. Under the rules described in paragraphs (d)(1), (d)(2), (e)(1)(i), (e)(1)(ii), and (e)(1)(iii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&amp;P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
<u>Post-1986 Pool</u>				
<u>Separate Category</u>				
Passive	400u		\$160	
General		(300u)		\$25
Carryforward pre-pooling deficit from Corp B		(200u)		0
2006 (from Corp B)	0u		50u	
2005 (from Corp B)	<u>0u</u>		<u>25u</u>	
	400u	<u>(500u)</u>		<u>\$25</u>

(iii) Post-transaction earnings. (A) In the taxable year ending on December 31, 2007, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

	<u>E&amp;P</u>	<u>Foreign Taxes</u>
<u>Post-1986 Pool Separate Category</u>		
Passive	150u	\$ 40
General	<u>400u</u>	<u>\$ 60</u>
	550u	\$100

(B) None of the earnings and profits qualify as subpart F income as defined in section 952(a). Under paragraph (f)(4)(i) of this section, the rules of paragraph (d)(2) of this section apply before the rules of paragraph (e)(1)(iii) of this section. Accordingly, post-transaction earnings in a separate category are first offset by a hovering deficit in the same separate category in the post-1986 pool. Thus, foreign surviving corporation's (300u) deficit in the general category offsets 300u of post-transaction earnings in the general category. After application of paragraph (d)(2) of this section, the (200u) deficit in the general category carried forward from foreign corporation B's pre-pooling aggregate deficit offsets the remaining 100u of post-transaction earnings in the general category. Accordingly, foreign surviving corporation has the following earnings and profits and foreign income taxes at the end of 2007:

	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
<u>Post-1986 Pool</u>				
<u>Separate Category</u>				
Passive	550u		\$200	
General			\$85	
Carryforward pre-pooling deficit from Corp B		(100u)		\$0
2006 (from Corp B)	0u		50u	
2005 (from Corp B)	<u>0u</u>		25u	
	550u	<u>(100u)</u>		<u>\$0</u>

(C) Under paragraph (d)(2)(iii) of this section, all of the \$25 of post-1986 foreign income taxes related to the (300u) hovering deficit in the general category is added to the foreign surviving corporation's post-1986 foreign income taxes of \$60 in that category (because post-transaction earnings in the general category have exceeded the deficit in that category). Under paragraph (e)(1)(iii)(C) of this section, the 50u and 25u of foreign income taxes associated with foreign corporation B's pre-1987 accumulated profits for 2006 and 2005 remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902-2(b)(2).

(5) Pro rata rule for earnings and deficits during transaction year. (i) For purposes of offsetting post-transaction earnings of a foreign surviving corporation under the rules described in paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section, the earnings and profits, and any related foreign income taxes, in each separate category for the taxable year of the foreign surviving corporation in which the transaction occurs shall be deemed to have been accumulated after such transaction in an amount which bears the same ratio to the undistributed earnings and profits of the foreign surviving corporation for such taxable year (computed without regard to any earnings and profits carried over) as the number of days in the taxable year after the date of transaction bears to the total number of days in the taxable year. See, e.g., §1.381(c)(2)-1(a)(7) Example 2 (illustrating application of this rule with respect to domestic corporations).

(ii) For purposes of determining the amount of pre-transaction deficits described in paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section, of a foreign surviving corporation that has a deficit in earnings and profits in any separate category for its taxable year in which the transaction occurs, unless the actual accumulated earnings and profits, or deficit, as of such date can be shown, such pre-transaction deficit, and any related foreign income taxes, shall be deemed to have accumulated in a manner similar to that described in paragraph (f)(5)(i) of this section. See, e.g., §1.381(c)(2)-1(a)(7) Example 4 (illustrating application of this rule with respect to domestic corporations).

(g) Effective date. This section shall apply to section 367(b) transactions that occur on or after November 6, 2006.

Par. 8. Section 1.367(b)-8 is added and reserved to read as follows:

§1.367(b)-8 Allocation of earnings and profits and foreign income taxes in certain foreign corporate separations. [Reserved]

Par. 9. Section 1.367(b)-9 is added to read as follows:

§1.367(b)-9 Special rule for F reorganizations and similar transactions.

(a) Scope. This section applies to a foreign section 381 transaction (as defined in §1.367(b)-7(a)) either--

(1) That is described in section 368(a)(1)(F); or

(2) That involves--

(i) At least one foreign corporation that holds no property and has no tax attributes immediately before the transaction, other than a nominal amount of assets (and related tax attributes) to facilitate its organization or preserve its existence as a corporation; and

(ii) No more than one foreign corporation that holds more than a nominal amount of property or has more than a nominal amount of tax attributes immediately before the transaction.

(b) Hovering deficit rules inapplicable. If a transaction is described in paragraph (a) of this section, a foreign surviving corporation shall succeed to earnings and profits, deficits in earnings and profits, and foreign income taxes without regard to the hovering deficit rules of §1.367(b)-7(d)(2), (e)(1)(iii), and (e)(2)(iii).

(c) Foreign divisive transactions. [Reserved]

(d) Examples. The following examples illustrate the principles of this section:

Example 1. (i) Facts. (A) Foreign corporation A is and always has been a wholly owned subsidiary of USP, a domestic corporation. Foreign corporation A was incorporated in 1995, and has always had a calendar taxable year. Foreign corporation A (and all of its respective qualified business units as defined in section 989) maintains a “u” functional currency. On December 31, 2006, foreign corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Passive	(1,000u)	\$ 5
General	<u>200u</u>	<u>\$200</u>
	(800u)	\$205

(B) On January 1, 2007, foreign corporation A moves its place of incorporation from Country 1 to Country 2 in a reorganization described in section 368(a)(1)(F).

(ii) Result. Under §1.367(b)-7(d), as modified by paragraph (b) of this section, the pre-transaction deficit of foreign corporation A will not hover. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes immediately after the foreign section 381 transaction:

<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Passive	(1,000u)	\$ 5
General	<u>200u</u>	<u>\$200</u>
	(800u)	\$205

Example 2. (i) Facts. (A) Foreign corporations B, C and D are and always have been wholly owned subsidiaries of USP, a domestic corporation. Foreign corporation B was incorporated in 2000 and foreign corporations C and D were incorporated in 2001. Foreign corporation B does not own any significant property and has no earnings and profits or foreign income taxes accounts. Both foreign corporations C and D have always had a calendar taxable year. Foreign corporations C and D (and all of their respective qualified business units as defined in section 989) maintain a “u” functional currency. On December 31, 2006, foreign corporations C and D have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign corporation C		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Passive	(900u)	\$ 50
General	<u>(200u)</u>	<u>\$100</u>
	(1100u)	\$150

Foreign corporation D		
<u>Separate Category</u>	<u>E&amp;P</u>	<u>Foreign Taxes</u>
Passive	1200u	\$400
General	<u>400u</u>	<u>\$100</u>
	1600u	\$500

(B) On January 1, 2007, USP foreign corporations C and D merge into foreign corporation B in a reorganization described in section 368(a)(1)(A).

(ii) Result. Although the merger is a foreign section 381 transaction involving a



foreign corporation with no property or tax attributes, paragraph (b) of this section does not apply because more than one foreign corporation with significant tax attributes is involved in the foreign section 381 transaction. Accordingly, under §1.367(b)-7(d), foreign surviving corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes immediately after the foreign section 381 transaction:

<u>Separate Category</u>	<u>Earnings &amp; Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&amp;P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
General	1200u	(900u)	\$400	\$ 50
Passive	<u>400u</u>	<u>(200u)</u>	<u>\$100</u>	<u>\$100</u>
	1600u	(1100u)	\$500	\$150

(e) Effective date. This section shall apply to section 367(b) transactions that occur on or after November 6, 2006.

Par. 10. In §1.381(a)-1, paragraph (c) is revised to read as follows:

§1.381(a)-1 General rule relating to carryovers in certain corporate acquisitions.

\* \* \* \* \*

(c) Foreign corporations. For additional rules involving foreign corporations, see §§1.367(b)-7 through 1.367(b)-9.

\* \* \* \* \*

Mark E. Matthews,  
Deputy Commissioner for Services and Enforcement.

Approved: July 20, 2006

Eric Solomon  
Acting Deputy Assistant Secretary (Tax Policy).