Therefore, it is not subject to the congressional review requirements in 5 U.S.C. 801–808.

**List of Subjects in 21 CFR Part 522**

Animal drugs.

■ Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 522 is amended as follows:

## PART 522—IMPLANTATION OR INJECTABLE DOSAGE FORM NEW ANIMAL DRUGS

■ 1. The authority citation for 21 CFR part 522 continues to read as follows:

**Authority:** 21 U.S.C. 360b.

**§ 522.1660a [Amended]**

■ 2. In § 522.1660a, remove paragraphs (e)(1)(i)(D) and (e)(1)(i)(E).

Dated: May 25, 2006.

**Stephen F. Sundlof,**

*Director, Center for Veterinary Medicine.*

[FR Doc. E6–8694 Filed 6–5–06; 8:45 am]

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

### 26 CFR Part 1

**[TD 9265]**

**RIN 1545–BF48**

# Guidance Under Section 7874 Regarding Expatriated Entities and Their Foreign Parents

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Temporary regulations.

**SUMMARY:** This document contains temporary regulations under section 7874 of the Internal Revenue Code (Code) relating to the determination of whether a foreign entity shall be treated as a surrogate foreign corporation under section 7874(a)(2)(B) of the Code. The text of these temporary regulations also serves as the text of the proposed regulations (REG–112994–06) set forth in the notice of proposed rulemaking on this subject published elsewhere in this issue of the **Federal Register**.

**DATES:** *Effective Date:* These regulations are effective June 6, 2006.

*Applicability Dates:* For dates of applicability, *see* § 1.7874–2T(j).

**FOR FURTHER INFORMATION CONTACT:** Milton Cahn, 202–622–3860 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

## Background

*A. Section 7874—Overview*

This document contains temporary amendments to 26 CFR part 1 under section 7874 of the Internal Revenue Code (Code). Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is defined in section 7874(a)(2)(A) as a domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation, and also as any U.S. person related (within the meaning of section 267(b) or 707(b)(1)) to such domestic corporation or partnership.

A foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), if, pursuant to a plan or a series of related transactions: (i) The foreign corporation directly or indirectly acquires substantially all the properties held directly or indirectly by a domestic corporation, or substantially all the properties constituting a trade or business of a domestic partnership; (ii) after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by (in the case of an acquisition with respect to a domestic corporation) former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or (in the case of an acquisition with respect to a domestic partnership) by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership (ownership percentage test); and (iii) the expanded affiliated group that includes the foreign corporation (EAG) does not have business activities in the foreign country in which the foreign corporation was created or organized that are substantial when compared to the total business activities of the EAG. Section 7874(c)(1) defines the term *expanded affiliated group* as an affiliated group defined in section 1504(a) but without regard to the exclusion of foreign corporations in section 1504(b)(3) and with a reduction of the 80 percent ownership threshold of section 1504(a) to a more-than-50 percent ownership threshold.

The tax treatment of expatriated entities and surrogate foreign corporations varies depending on the level of owner continuity. If the percentage of stock (by vote or value) in the surrogate foreign corporation held by former owners of the domestic entity, by reason of holding an interest in the domestic entity, is 80 percent or more, the surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code. If such ownership percentage is 60 percent or more (but less than 80 percent), the surrogate foreign corporation is treated as a foreign corporation but certain income or gain required to be recognized by the expatriated entity under section 304, 311(b), 367, 1001, or any other applicable provision with respect to the transfer of property (other than inventory or similar property) or the license of property cannot be offset by net operating losses or credits (other than credits allowed under section 901). These measures generally apply from the first date properties are acquired pursuant to the plan through the end of the 10-year period following the completion of the acquisition.

Section 7874(c)(4) provides that transfers of properties or liabilities (including by contribution or distribution) are disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of the section.

The IRS and Treasury Department have broad authority to issue regulations under section 7874. Section 7874(c)(6) authorizes the Secretary of the Treasury to prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and to treat stock as not stock. In addition, under section 7874(g) the Secretary of the Treasury is authorized to provide regulations needed to carry out the section. Those regulations could include guidance providing adjustments to the application of the section as are necessary to prevent the avoidance of the section, including avoidance through the use of related persons, pass-through or other non-corporate entities, or other intermediaries.

The legislative history of section 7874 indicates that the section was intended to apply to so-called inversion transactions in which a U.S. parent corporation of a multinational corporate group is replaced by a foreign entity. *See* H.R. Conf. Rep. No. 108–755, 108th Cong., 2d Sess., at 568 (Oct. 7, 2004). The Senate Finance Committee stated its belief ‘‘that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed.’’ S. Rep. No. 108–192, 108th Cong., 1st Sess., at 142 (Nov. 7, 2003). In particular, Congress believed that such transactions permit corporations and other entities to

continue to conduct business in the same manner as they did prior to the inversion, but with the result that the group that includes the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on U.S. operations. *See* S. Rep. No. 108–192, at 142 (Nov. 7, 2003); *see also* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, at 343 (May 2005).

The IRS and Treasury Department have issued temporary and proposed regulations under section 7874 relating to the application of section 7874(c)(2) (affiliated-owned stock rule), under which stock held by members of the expanded affiliate group that includes the acquiring foreign corporation (EAG) is not taken into account for purposes of the ownership percentage test of section 7874(a)(2)(B)(ii). *See* TD 9238, 2006–6 I.R.B. 408 (Feb. 6, 2006). Those regulations ensure that the affiliated-owned stock rule cannot be used to avoid the application of section 7874, through the use of hook stock or otherwise, to situations where that provision should apply. In addition, those regulations ensure that this test does not apply to certain transactions that are properly viewed as outside the scope of section 7874.

*B. Temporary and Proposed Regulations*

The temporary and proposed regulations provide guidance on the determination of whether a foreign entity is treated as a surrogate foreign corporation under section 7874(a)(2)(B) of the Code. In particular, the regulations address the indirect acquisition of properties, stock held by reason of holding an interest in a domestic entity, the substantial business activities of an EAG, prevention of the avoidance of section 7874 in certain circumstances, and certain effects of being treated as a domestic corporation under section 7874(b).

1. Indirect Acquisition of Properties

Section 7874 does not apply unless a foreign entity completes a direct or indirect acquisition of defined properties. The legislative history of the section indicates that Congress intended the acquisition of stock in a corporation to be considered an indirect acquisition of the properties held directly or indirectly by the corporation. *See* H.R. Conf. Rep. No. 108–755, 108th Cong., 2d Sess., at 573 (Oct. 7, 2004) (''U.S. corporation becomes a subsidiary of a foreign incorporated entity or otherwise transfers substantially all of its properties''). The IRS and Treasury Department believe that guidance regarding the indirect acquisition of properties held directly or indirectly by a domestic corporation is needed to refine further the parameters of the provision's scope.

The statute also applies to indirect acquisitions of properties constituting a trade or business of a domestic partnership. The IRS and Treasury Department are considering guidance regarding the application of this part of the statute, but are not issuing any such guidance at this time.

2. Stock Held by Reason of Holding an Interest in the Domestic Entity

Section 7874 requires a determination of the amount of stock in the acquiring foreign entity that is held by former shareholders or partners of the domestic corporation or partnership ''by reason of'' their holding stock or a partnership interest in the domestic entity. The IRS and Treasury Department believe that guidance is needed as to how this determination is made in certain circumstances.

3. Substantial Business Activities of the EAG

Section 7874 does not apply if the EAG has business activities in the foreign country in which, or under the laws of which, the acquiring foreign entity was created or organized that are substantial when compared to the total business activities of the EAG. The IRS and Treasury Department believe that Congress was concerned about transactions where the new foreign parent entity is incorporated in a country in which the EAG does not have a bona fide business presence that is meaningful in the context of the group's overall business. *See* S. Rep. No. 108–192, 108th Cong., 2d Sess., at 142 (Nov. 7, 2003) (''The Committee believes that inversion transactions resulting in minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed.''). The IRS and Treasury Department believe that guidance is necessary to ensure proper application of the substantial-business-activities rule.

4. Preventing Avoidance of the Purposes of the Section

(i). Publicly Traded Foreign Partnership as Acquiring Entity

The IRS and Treasury Department are aware of recent transactions in which taxpayers have attempted to avoid the application of section 7874 through the use of a foreign partnership. These transactions involve the acquisition of substantially all the properties of a domestic corporation or partnership by a foreign entity that is considered a foreign partnership for U.S. federal income tax purposes, despite the fact that interests in the entity are (or will be) publicly traded on a securities exchange. Although a partnership is a flow-through entity for Federal income tax purposes, the substitution of a foreign partnership for a domestic corporation as the parent entity of a multinational group can create many of the same opportunities for U.S. tax avoidance that Congress sought to curtail by enacting section 7874 (namely, removal of foreign operations from U.S. taxing jurisdiction and the use of earnings-stripping techniques to reduce U.S. tax on income from domestic operations). Section 7874(g) is intended to provide authority to address these types of issues.

Under section 7704 of the Code, a publicly traded partnership is generally treated as a corporation for all purposes of the Code. Section 7704(c), however, generally provides an exception from corporate treatment if 90 percent or more of the partnership's gross income for a taxable year consists of passive income such as dividends. This exception does not apply on a look-through basis in the case of payments from related parties, so the exception can be satisfied even if the underlying earnings from which the income is paid are not passive in nature. The legislative history of section 7704 indicates that the rationale for this exception was to preserve flow-through tax treatment where a partnership simply holds investments that the partners could have independently acquired, as opposed to business activities that would normally be conducted in corporate form and taxed at the entity level. *See* H.R. Rep. 100–391 (Oct. 26, 1987) at 1066–1067. In the case of a foreign eligible entity that acquires directly or indirectly substantially all the properties of a domestic corporation, or substantially all the properties constituting a trade or business of a domestic partnership, the rationale for the exception provided by section 7704(c) does not clearly apply.

The IRS and Treasury Department believe it is appropriate to exercise their regulatory authority under section 7874(g) to make adjustments to the application of the section to prevent avoidance of the purpose of the section through the use of certain non-corporate entities. In the absence of regulations making a relevant adjustment to the application of the section, a publicly traded foreign partnership that is not treated as a corporation under section 7704 arguably might not be treated as a surrogate foreign corporation under

section 7874(a)(2)(B) on the grounds that the entity is considered a partnership rather than a corporation for Federal income tax purposes. The IRS and Treasury Department believe that it is contrary to the broad anti-abuse purposes of section 7874 for the provisions to be avoided in circumstances raising the same type of earnings stripping and other concerns simply by substituting a partnership for a corporation as the acquiring entity (often through the ease of a check the box election). To ensure that the purposes of section 7874 are not avoided in this manner, the regulations provide that a publicly traded foreign partnership that is not treated as a corporation under section 7704 will be treated as a foreign corporation for purposes of applying section 7874(a)(2)(B) to determine whether the acquiring foreign entity is a surrogate foreign corporation.

(ii). Options and Similar Interests

The IRS and Treasury Department are also concerned that taxpayers may attempt to avoid the purposes of section 7874 through the use of options and similar interests related to stock of the foreign acquirer. Congress foresaw the possibility of this type of avoidance and provided a specific grant of regulatory authority in this regard in section 7874(c)(6). The IRS and Treasury Department believe it is appropriate to exercise that authority at this time.

5. Effects of Section 7874(b)

Under section 7874(b), a foreign corporation is treated for purposes of the Code as a domestic corporation if it would be a surrogate foreign corporation if the continuing ownership threshold of section 7874(a)(2)(B)(ii) were 80 percent rather than 60 percent. This ''domestication'' rule gives rise to certain issues relating to the application of other provisions of the Code. The IRS and Treasury Department believe that guidance on these issues is necessary to avoid uncertainty.

**Explanation of Provisions**

*A. Indirect Acquisition of Properties Held by a Domestic Corporation*

Commentators requested that specific guidance be provided regarding the application of section 7874 to acquisitions of stock, to clarify that such acquisitions are indirect acquisitions of the properties held by the corporation whose stock is acquired.

To this end, section 1.7874–2T(b) of the regulations provides that, for purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of stock in a domestic corporation is considered to be an indirect acquisition of a proportionate amount of the properties held directly or indirectly by the domestic corporation. Further, the regulations provide that an acquisition by a foreign corporation of an interest in a partnership that holds stock in a domestic corporation is considered an indirect acquisition of a proportionate amount of the properties held directly or indirectly by the domestic corporation.

The regulations also provide that a foreign corporation's acquisition of stock in a second foreign corporation is not considered an indirect acquisition by the first foreign corporation of any properties held by a domestic corporation or domestic partnership owned wholly or partly by the second foreign corporation. The IRS and Treasury Department believe that it was not Congress's intent for section 7874 to apply to indirect acquisitions by foreign corporations of domestic entities that were already owned by a foreign corporation before the acquisition. *See* H.R. Conf. Rep. No. 108–755, 108th Cong., 2d Sess., at 568 (Oct. 7, 2004).

Finally, the regulations provide that, in acquisitions in which a corporation (either domestic or foreign) which is under the control of a foreign corporation acquires the stock or assets of a domestic corporation in exchange for stock of the controlling foreign corporation, such foreign corporation will be considered to have made the acquisition of a proportionate amount of the domestic corporation's stock or assets.

*B. Stock Held by Reason of Holding an Interest in the Domestic Entity*

Section 1.7874–2T(c) of the regulations provides that, for purposes of section 7874(a)(2)(B)(ii), stock of the acquiring foreign entity that is received in exchange for stock of a domestic corporation, or in exchange for a capital or profits interest in a domestic partnership, is considered to be stock held by reason of holding stock in the domestic corporation or holding the interest in the domestic partnership, as the case may be. Moreover, the regulations provide that, where, in the same transaction or series of related transactions, other property is also contributed to the foreign entity in exchange for its stock, the amount of stock held by a former shareholder of the domestic corporation or former partner of the domestic partnership for section 7874 purposes is determined on the basis of the relative value of the property in exchange for which the foreign entity's stock was issued. This rule is subject to the potential application of section 7874(c)(4), which requires that transfers be disregarded if they occur as part of a plan to avoid the purposes of section 7874.

The regulations also provide, for purposes of clarity, that the terms *former shareholders* and *former partners* mean any persons who held an ownership interest in the domestic entity before the acquisition, regardless of whether they continue to hold such an interest in the domestic entity after the acquisition.

*C. Substantial Business Activities in the Foreign Country of Incorporation*

The regulations provide both an all-facts-and-circumstances test and a bright-line safe harbor test of whether an EAG has substantial business activities in the acquiring foreign entity's country of incorporation when compared to the total business activities of the EAG. The IRS and Treasury Department believe that this dual approach appropriately provides taxpayers with the certainty of an objective and clear safe harbor, while preserving the ability of a taxpayer to conclude, in a case that is not within the scope of the safe harbor, that section 7874 is not applicable to a foreign entity's acquisition of the stock or assets of a domestic entity where, after the acquisition, the group has a meaningful and bona fide business presence in the relevant foreign country. This dual approach was also recommended by a commentator.

1. Facts and Circumstances Test

Section 1.7874–2T(d)(1) of the regulations provides, as a general rule, that the determination of whether the EAG has substantial business activities in the relevant foreign country, when compared to the total business activities of the EAG, will be based on an analysis of all the facts and circumstances of each case. The regulations set forth a non-exclusive list of factors to be considered in the analysis. The weight given to any factor will depend on the particular circumstances. The listed factors include, among other factors, the EAG's local employee headcount and payroll, property, and sales; the EAG's historical presence in the foreign country; its management activities in the country; and the strategic importance to the EAG as a whole of the business activities in that country.

The regulations state that the presence or absence of any factor, or any particular number of factors, in the list is not determinative, and that there is no minimum percentage of the group's total employee headcount, payroll, assets, or sales that must be shown to be in the

foreign country. Nevertheless, the determination of substantiality for this purpose must be made on the basis of a comparison to the total activities of the EAG, and the factors in the list must be evaluated accordingly.

Congress intended to prevent taxpayers from avoiding section 7874 through tax-motivated transfers of properties or liabilities, by providing in section 7874(c)(4) that such transfers shall be disregarded. Therefore, in analyzing the facts and circumstances to determine whether an EAG's business activities in the relevant foreign country are substantial within the meaning of the statute, it is necessary to disregard any assets, liabilities or activities in the foreign country that were transferred pursuant to a plan a principal purpose of which was to avoid section 7874.

The regulations also provide that certain factors are not to be given weight in making the determination under the facts and circumstances test. These factors include any assets that are temporarily located in the foreign country for the purpose of avoiding the purposes of section 7874.

Although the list of factors to be disregarded does not include passive assets, the IRS and Treasury Department believe that the statutory phrase ''business activities'' ordinarily does not include passive investment activities and related income and assets. Investment assets may include intangible assets that have significant value but are not being exploited by any member of the EAG in the course of active business activities. In contrast, intangibles that are used in the course of active business operations by EAG members will normally be accorded due weight by the IRS in the application of the all-facts-and-circumstances test. In order to preserve a wide breadth for the all-facts-and-circumstances rule, investment assets and income have not been included in the list of factors to be given no weight, but it is expected that such passive assets and income normally would not be given any significant weight.

2. Safe Harbor Test

Section 1.7874–2T(d)(2) of the regulations sets forth an alternative, safe harbor test for determining whether, after the acquisition, an EAG has substantial business activities in the relevant foreign country, when compared to the total business activities of the EAG. The safe harbor test will only be satisfied by an EAG that has a substantial and bona fide business presence in the relevant foreign country. The IRS and Treasury Department intend, however, that even if the EAG does not satisfy the safe harbor test, it still may satisfy the facts and circumstances test of § 1.7874–2T(d)(1). This safe harbor test is consistent with the approach suggested by a commentator.

The safe harbor test is satisfied if the EAG satisfies three conditions, relating to employees, assets, and sales. Under section 7874, the determination of whether an EAG's business activities in the relevant foreign country are substantial when compared to the total business activities of the EAG is to be made ''after the acquisition.'' Given the practical difficulty of measuring the various business factors on dates other than the periodic dates during the year as of which an EAG's management accounts are prepared, the regulations provide for the determination of group employees, assets, and sales during a twelve month testing period ending on the last day of the monthly or quarterly accounting period in which the completion of the acquisition occurs. Moreover, the determination of facts existing on that day for purposes of the safe harbor rule is subject to the application of section 7874(c)(4), under which any transfer is disregarded if made pursuant to a plan a principal purpose of which is to avoid the purposes of section 7874.

The first condition of the safe harbor rule is that, after the acquisition, the group employees based in the foreign country account for at least 10 percent (by headcount and compensation) of total group employees.

The term *group employee* is defined as a common law employee of one or more group members on a full time basis throughout the twelve-month testing period. An employee is considered to be based in a country only if the employee spent more time providing services in such country than in any other country throughout such twelve-month period.

The second condition is that, after the acquisition, the total value of the group assets located in the foreign country represents at least 10 percent of the total value of all group assets.

The term *group assets* is defined as tangible property used or held for use in the active conduct of a trade or business by a group member. An item of tangible personal property is considered to be located in a country only if such item was physically present in such country for more time than in any other country during the twelve-month testing period. Value is determined on a gross basis (that is, without reduction for liabilities) after the acquisition. Group assets acquired or transferred as part of a plan a principal purpose of which is to avoid the application of section 7874 are disregarded.

The IRS and Treasury Department specifically excluded intangible assets from the definition of group assets, even though intangibles may be used in the course of active business operations. The reason for excluding intangibles is that they frequently present difficult factual issues relating to their use, value, and location. Therefore, their inclusion in the definition of group assets for purposes of the safe harbor test would introduce a significant element of uncertainty in many cases as to the application of the safe harbor rule. Given that the purpose of the safe harbor rule is to provide a clear, bright-line test, it was decided that the definition of group assets should not include intangibles. This exclusion was also suggested by a commentator.

The third condition of the safe harbor rule is that, during the twelve-month testing period, the group sales made in the foreign country accounted for at least 10 percent of total group sales.

The term *group sales* is defined as sales by group members, measured by gross receipts from such sales. Group sales are considered to be made in a particular country only if the services, goods or other property transferred by those sales are sold for use, consumption or disposition in that country. The term ''sales'' includes sales of services and of the use of property as well as sales involving the transfer of title to personal property.

Consideration was given to the use of thresholds higher than the 10 percent figure used in the safe harbor rule. However, based on comments received, the IRS and Treasury Department believe that 10 percent is a reasonable threshold.

*D. Prevention of Avoidance of Section 7874*

1. Acquisitions by Publicly Traded Foreign Partnerships

It has been brought to the attention of the IRS and Treasury that taxpayers are implementing structures (including partnership structures) that result in many of the same overall tax consequences as structures that Congress intended to be subject to section 7874, but are taking the position that these structures are not within the scope of section 7874. As a result, the IRS and Treasury Department have identified acquisitions by certain publicly traded foreign partnerships as a category of transactions requiring a special rule in order to prevent avoidance of the purposes of section 7874. Section 7874(g) provides broad

regulatory authority to adjust the application of the section to prevent avoidance of the purposes of the section through the use of non-corporate entities. Commentators have also agreed that this authority exists. Accordingly, § 1.7874–2T(e) provides that a publicly traded foreign partnership will be treated as a foreign corporation for purposes of applying section 7874(a)(2)(B) and § 1.7874–2T to determine whether it is a surrogate foreign corporation.

The regulations define *publicly traded foreign partnership* for purposes of this rule as any foreign partnership that would, but for the application of section 7704(c), be treated as a corporation under section 7704 of the Code at any time during the two-year period following the partnership's completion of an acquisition described in section 7874(a)(2)(B)(i). Under section 7704, a partnership is generally treated as a corporation if interests in the partnership are traded on an established securities market, or if interests in the partnership are readily tradable on a secondary market or the substantial equivalent. Section 7704(c) generally provides an exception for a publicly traded partnership where 90 percent or more of its gross income consists of qualifying income (which includes dividends from controlled subsidiaries).

If a publicly traded foreign partnership is within the scope of the regulations, the foreign partnership will be considered to be a foreign corporation, and if it meets the requirements of section 7874(c)(1), may be a member of the EAG, in determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B). For purposes of applying the substantial business activities test of section 7874(a)(2)(B)(iii), the foreign partnership will be considered to be a corporation created or organized in, or under the laws of, the foreign country in which, or under the laws of which, the foreign partnership was created or organized. Moreover, interests in the foreign partnership will be treated as stock of such foreign corporation for purposes of applying the ownership percentage test of section 7874(a)(2)(B)(ii).

If the foreign partnership is considered a surrogate foreign corporation, and the ownership percentage under section 7874(a)(2)(B)(ii) is at least 80 percent, the foreign partnership will be treated under section 7874(b) as a domestic corporation for all purposes of the Code. A conversion rule is provided in the regulations to clarify the Federal income tax consequences of the deemed change from a foreign partnership to a domestic corporation.

In contrast, if the entity is considered a surrogate foreign corporation but the ownership percentage under section 7874(a)(2)(B)(ii) is at least 60 percent but less than 80 percent, the foreign entity will be a foreign partnership for all purposes of the Code, but section 7874(a)(1) will govern the Federal income tax treatment of the expatriated entity (that is, the domestic corporation or domestic partnership whose assets were acquired directly or indirectly by the foreign partnership, and any United States person who is related under sections 267(b) or 707(b)(1)).

Finally, if the publicly traded foreign partnership is not considered to be a surrogate foreign corporation, because the ownership percentage under section 7874(a)(2)(B)(ii) is less than 60 percent, because the EAG has substantial business activities in the country in which, or under the laws of which, the foreign partnership was created or organized, or otherwise, section 7874 will not apply to the foreign partnership, or to the domestic entity, the assets of which it directly or indirectly acquired, and the foreign partnership will continue to be classified as a foreign partnership for all purposes of the Code.

Section 1.7874–2T(e) applies equally to foreign entities that are considered partnerships under both foreign law and U.S. federal income tax law, and foreign entities that are considered corporate entities under foreign law but are treated as partnerships for U.S. federal income tax purposes under Treasury regulation § 301.7701–3.

The regulations include a provision that explicitly removes from the scope of section 7874 a partnership's deemed acquisition of assets and liabilities under § 1.708–1(b)(4) upon a termination of the partnership due to change of ownership. In the absence of such a provision, section 7874 might apply to a deemed acquisition by a publicly traded foreign partnership of a domestic entity representing at least 60 percent of the value of the partnership's assets, merely because of active trading of interests in the partnership. There is no indication in the legislative history that section 7874 was intended to apply in that situation.

Comments were received by the IRS and Treasury Department regarding the consequences under section 7874 where a foreign partnership satisfies the definition of a surrogate foreign corporation when treated as a foreign corporation for definitional purposes. It was argued that, in cases of 80 percent or greater ownership of the foreign partnership by former owners of the acquired domestic entity by reason of their former ownership, the foreign partnership should not be treated as a domestic corporation, despite the language of section 7874(b), but rather should be treated as a domestic partnership. The reasons given included: (1) Because a partnership is a flow-through entity for tax purposes, the United States persons owning interests in the partnership would be taxable on the partnership's income, including subpart F income attributable to earnings-stripping transactions between domestic subsidiaries of the partnership and foreign subsidiaries; and (2) the entity classification rules of §§ 301.7701–2 and 301.7701–3 are intended to allow taxpayers to choose whether a foreign eligible entity is a corporation or partnership for Federal income tax purposes, and section 7874(b) does not impinge on that freedom of choice, but only deems a foreign corporation to be a domestic corporation.

On balance, the IRS and Treasury Department do not find these arguments determinative. Section 7874 does not focus on the taxation of the owners of the acquired domestic entity and the acquiring foreign entity, nor does the statute focus on whether such owners are United States persons or foreign persons. The section imposes tax consequences only on either the acquiring foreign entity or the acquired domestic entity (or related domestic entities). Therefore, the fact that United States persons owning interests in the acquiring partnership would be subject to United States tax on the partnership's income is not determinative of the appropriate treatment of a foreign partnership that is within the scope of section 7874(b) after application of the anti-avoidance rule of paragraph (e) of these regulations.

The argument relating to the entity classification rules has perhaps a stronger foundation. However, for the reasons mentioned above, the IRS and Treasury Department believe that the intention of Congress in enacting both section 7874 and section 7704 is carried out by a rule which treats a publicly traded foreign partnership as a domestic corporation in those circumstances in which the partnership otherwise would be within the scope of section 7874(b) if it were a corporation.

The IRS and Treasury Department recognize that the use of a foreign partnership that is not publicly traded, or the use of a domestic partnership, to acquire the properties of a domestic corporation might enable taxpayers to avoid the purposes of section 7874 in

certain cases. Comments are solicited below on whether future regulations under section 7874 or another provision of the Code should address these situations.

2. Options and Similar Interests Treated as Stock of the Foreign Acquirer

Based on the regulatory authority provided in section 7874(c)(6), § 1.7874–2T(f) of the regulations provides that options and similar interests held by a former shareholder or former partner of the expatriated entity by reason of holding stock or a partnership interest in the expatriated entity will be treated, for purposes of the ownership test of section 7874(a)(2)(B)(ii), as exercised, to the extent that the effect is to treat the foreign corporation as a surrogate foreign corporation. An interest that is similar to an option is defined for these purposes as including, without limitation, a warrant, a convertible debt instrument or other convertible instrument, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.

These rules are consistent with existing rules under section 382, which has identical statutory language, in section 382(k)(6)(B), to that of section 7874(c)(6). The IRS and Treasury Department are continuing to study whether other types of interests should also be treated as stock of the acquirer under regulations issued under the authority of section 7874(c)(6).

*E. Effects of Section 7874(b)*

Section 1.7874–2T(g) provides that a foreign corporation that is treated as a domestic corporation under section 7874(b) is treated, for purposes of the Code other than determining whether the foreign corporation is a surrogate foreign corporation, as converting to a domestic corporation pursuant to a reorganization described in section 368(a)(1)(F) immediately before the commencement of the acquisition. It follows that, in a case in which the foreign corporation was newly formed for the purpose of the transaction, the effect will be that it is treated as a domestic corporation from its inception. Further, § 1.7874–2T(h) provides that, if section 7874(b) applies to a surrogate foreign corporation, section 367 does not apply to any transfer of stock or other property to such entity as part of the acquisition described in section 7874(a)(2)(B)(i).

*F. Effective Dates*

The regulations apply to acquisitions completed on or after the date of their publication in the **Federal Register**. However, taxpayers may apply the regulations to acquisitions completed prior to such date, but must do so consistently with respect to all acquisitions within the scope of the regulations.

**Request for Comments**

The IRS and Treasury Department are considering issuing subsequent public guidance that addresses additional issues under section 7874. This guidance may address issues related to (1) The determination of whether there has been a direct or indirect acquisition of substantially all the properties held directly or indirectly by a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership; (2) the requirement that such acquisition be pursuant to a plan or a series of related transactions; (3) the treatment of stock sold in a public offering that is related to the acquisition; and (4) the disregard of transfers of properties or liabilities if the transfers are part of a plan a principal purpose of which is to avoid the purposes of section 7874. The IRS and Treasury Department specifically request comments regarding appropriate rules in relation to these issues arising under section 7874.

One commentator has recommended that preferred stock described in section 1504(a)(4) should be disregarded in applying the ownership percentage test of section 7874(a)(2)(B)(ii) and the special safe harbor rules of § 1.7874–1T(c). The IRS and Treasury Department are carefully considering this recommendation and solicit additional comments as to whether future guidance should include such a rule.

In addition, the IRS and Treasury Department are considering whether and how to amend § 1.367(a)–3(c), which deals with the tax consequences of a United States person's transfer of stock of a domestic corporation to a foreign acquiring corporation, as a result of the enactment of section 7874 and the promulgation of regulations thereunder. A commentator has asked for these amendments. Additional comments are requested.

Based on comments received, the IRS and Treasury Department identified inversion transactions using a publicly traded foreign partnership as the new foreign parent entity of the inverted group as a category of transactions requiring a special rule in order to prevent avoidance of the purposes of section 7874, in light of the Congressional purpose in enacting section 7704. Comments are requested as to whether other types of partnerships, such as foreign partnerships that are not publicly traded and domestic partnerships (including limited liability companies), could also be used to avoid the purposes of sections 7874 and 7704, and whether further guidance addressing such avoidance is warranted.

**Effective Date**

Section 1.7874–2T applies to acquisitions completed on or after June 6, 2006. Taxpayers may elect to apply the section to acquisitions completed prior to that date, but must apply it consistently to all acquisitions within its scope.

**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.

These regulations are necessary to provide immediate guidance to prevent avoidance of section 7874 in situations where it should apply as well as to provide immediate guidance on situations where it should not apply. Accordingly, good cause is found for dispensing with notice and public comment pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f), this Treasury decision will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal author of this regulation is Jefferson VanderWolk, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in its 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 continues to read, in part, as follows:

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

■ **Par. 2.** Sections 1.7874–2T is added to read as follows:

**§ 1.7874–2T Surrogate foreign corporation (temporary).**

(a) *Scope.* This section provides rules under section 7874(a)(2)(B) for determining whether a foreign corporation shall be treated as a surrogate foreign corporation. Paragraph (b) of this section provides rules under section 7874(a)(2)(B)(i) regarding the indirect acquisition of properties held directly or indirectly by a domestic corporation or domestic partnership. Paragraph (c) of this section provides rules under section 7874(a)(2)(B)(ii) for identifying stock of the entity held by former shareholders or partners of the domestic entity by reason of holding stock or a partnership interest in the domestic entity. Paragraph (d) of this section provides rules under section 7874(a)(2)(B)(iii) for determining whether the expanded affiliated group (as defined in section 7874(c)(1)) that includes the entity (EAG) has substantial business activities in the foreign country in which, or under the laws of which, the entity was created or organized, when compared to the total business activities of the EAG. Paragraph (e) of this section provides rules under which a publicly traded foreign partnership is treated as a foreign corporation for purposes of determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B), and rules regarding the consequences under the Code if a partnership is treated as a surrogate foreign corporation. Paragraph (f) of this section provides rules under which certain interests held by former shareholders or partners of the domestic entity are treated as stock of the foreign entity making the acquisition described in section 7874(a)(2)(B)(i). Paragraph (g) of this section provides rules relating to the change in status from a foreign corporation to a domestic corporation under section 7874(b). Paragraph (h) of this section provides that section 367 is not applicable to the transfer of assets or stock to a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b).

(b) *Indirect acquisition of properties*—(1) *Acquisition of stock of a domestic corporation.* For purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of stock of a domestic corporation is considered an indirect acquisition by such foreign corporation of a proportionate amount of the properties held directly or indirectly by such domestic corporation.

(2) *Acquisition of stock of a foreign corporation.* For purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of stock of a second foreign corporation is not considered an indirect acquisition by the first foreign corporation of any properties held directly or indirectly by a domestic corporation or domestic partnership owned directly or indirectly, wholly or partly, by the second foreign corporation.

(3) *Acquisition of an interest in a partnership.* For purposes of section 7874(a)(2)(B)(i), an acquisition by a foreign corporation of a capital or profits interest in a foreign or domestic partnership that holds stock in a domestic corporation is considered an indirect acquisition by such foreign corporation of a proportionate amount of the properties held directly or indirectly by such domestic corporation.

(4) *Acquisition of stock or assets of a domestic corporation by controlled subsidiary.* For purposes of section 7874(a)(2)(B)(i) and paragraph (b)(1) of this section, if a corporation acquires stock or assets of a domestic corporation in exchange for stock of a foreign corporation which owns directly or indirectly, after the acquisition, more than 50 percent of the stock (by vote or value) of the acquiring corporation, such foreign corporation is considered as acquiring a proportionate amount of such stock or assets of the domestic corporation.

(5) *Examples.* The application of this paragraph is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003. The examples read as follows:

*Example 1. Acquisition of stock of domestic corporation.*—A is a domestic corporation with 100 shares of a single class of common stock outstanding. F, a foreign corporation, acquires 25 shares of A stock from a shareholder of A. For purposes of section 7874(a)(2)(B)(i), F is considered to have made an indirect acquisition of 25% of the properties held directly or indirectly by A.

*Example 2. Acquisition of stock of foreign corporation.*—The facts are the same as in Example 1 except as follows: All of A's stock is held by B, a foreign corporation. C, a foreign corporation, acquires 25 shares of B stock from a shareholder of B. For purposes of section 7874(a)(2)(B)(i), C is not considered to have made an indirect acquisition of any portion of the properties held directly or indirectly by A.

*Example 3. Acquisition of partnership interest.*—D is a partnership which owns all of the issued and outstanding stock of E, a domestic corporation. G, a foreign corporation, acquires a 40% interest in D from a partner in D. For purposes of section 7874(a)(2)(B)(i), G is considered to have made an indirect acquisition of 40% of the properties held directly or indirectly by E.

*Example 4. Acquisition by controlled corporation.*—FS, a foreign corporation, is 90% owned by foreign corporation FP. Pursuant to a plan of reorganization, FS acquires all the stock of DT, a domestic corporation, in exchange for stock of FP which is exchanged with the shareholders of DT on a one-for-one basis. For purposes of section 7874(a)(2)(B)(i) and paragraph (b)(1) of this section, FP is considered to have acquired 90% of the stock of DT and thus to have made an indirect acquisition of 90% of the properties held directly or indirectly by DT. If FS had acquired substantially all the assets of DT, rather than the stock of DT, in exchange for stock of FP, FP would be considered to have acquired 90% of the assets of DT for purposes of section 7874(a)(2)(B)(i).

(c) *Stock held by former shareholders or partners by reason of holding stock or a partnership interest in the domestic entity*—(1) *General rule.* For purposes of section 7874(a)(2)(B)(ii), stock of the foreign corporation which is received by a former shareholder of the domestic corporation in exchange for stock of the domestic corporation is considered stock held by reason of holding stock in the domestic corporation. Similarly, for purposes of section 7874(a)(2)(B)(ii), stock of the foreign corporation which is received by a former partner of the domestic partnership in exchange for a capital or profits interest in the domestic partnership is considered stock held by reason of holding a capital or profits interest in the domestic partnership. Subject to section 7874(c)(4), in cases where the foreign corporation also issues stock to a former shareholder of the domestic corporation or partner of the domestic partnership in the same transaction or series of transactions in exchange for consideration other than stock in the domestic corporation or a capital or profits interest in the domestic partnership, the percentage of the foreign corporation's stock considered to be held by former shareholders of the domestic corporation or former partners of the domestic partnership by reason of holding stock in the domestic corporation or a capital or profits interest in the domestic partnership shall be determined on the basis of the relative value of the property in exchange for which the foreign corporation's stock was issued.

(2) *Former shareholders and former partners.* For purposes of this section, former shareholders of the domestic corporation are persons who held stock in the domestic corporation before the acquisition, including persons (if any) who held stock in the domestic corporation both before and after the acquisition. Former partners of the domestic partnership are persons who

held a capital or profits interest in the domestic partnership before the acquisition, including persons (if any) who held a capital or profits interest in the domestic partnership both before and after the acquisition.

(3) *Example.* The following example illustrates the application of this paragraph:

*Example. Contribution of stock of domestic and foreign corporations.* A holds all of the issued and outstanding common stock of DC, FC1, FC2, and FC3. DC is a domestic corporation, and FC1, FC2, and FC3 are foreign corporations. Each of DC, FC1, FC2, and FC3 has only one class of stock outstanding. DC's outstanding stock is worth $40x, FC1's outstanding stock is worth $20x, FC2's outstanding stock is worth $25x, and FC3's outstanding stock is worth $15x. In a transaction subject to section 351, A contributes the stock of DC, FC1, FC2, and FC3 to FP, a foreign corporation, in exchange for all of the issued and outstanding common stock of FP. The transaction occurs after March 4, 2003. For purposes of section 7874(a)(2)(B)(ii), A is considered to hold 40% of the stock of FP by reason of holding stock in DC.

(d) *Substantial business activities of the EAG*—(1) *General rule*—(i) *Facts and circumstances test.* Subject to paragraph (d)(2) of this section, the determination of whether, after the acquisition, the EAG has substantial business activities in the foreign country in which, or under the law of which, the acquiring foreign entity is created or organized, when compared to the total business activities of the EAG, shall be made on the basis of all of the facts and circumstances. However, the factors described in paragraph (d)(1)(iii) of this section shall not be taken into account in making the determination. For the EAG to have substantial business activities in the foreign country when compared to the total business activities of the EAG, there is no minimum percentage of its total business activities (regardless of how measured) that must be in the foreign country. It is necessary, however, for the determination of substantiality to be made on the basis of a comparison to the total business activities of the EAG, and the factors set forth in paragraph (d)(1)(ii) of this section are to be evaluated accordingly. Thus, it is possible that the business activities of an EAG in a particular country would be substantial when compared to the total business activities of such EAG, but the identical business activities of another EAG in the same country would not be substantial when compared to the total business activities of that EAG because the total business activities of the second EAG were much more extensive than the total business activities of the first EAG.

(ii) *Factors to be considered.* Relevant factors indicating that the EAG has substantial business activities in the foreign country when compared to the total business activities of the EAG include, but are not limited to, the factors set forth below. The presence or absence of any factor, or of a particular number of factors, is not determinative. Moreover, the weight given to any factor (whether or not set forth below) depends on the particular case. Relevant factors include, but are not limited to—

(A) *Historical presence.* The conduct of continuous business activities in the foreign country by EAG members prior to the acquisition;

(B) *Operational activities.* Business activities of the EAG in the foreign country occurring in the ordinary course of the active conduct of one or more trades or businesses, involving—

(*1*) Property located in the foreign country which is owned by members of the EAG;

(*2*) The performance of services by individuals in the foreign country who are employed by members of the EAG; and

(*3*) Sales to customers in the foreign country by EAG members;

(C) *Management activities.* The performance in the foreign country of substantial managerial activities by EAG members' officers and employees who are based in the foreign country;

(D) *Ownership.* A substantial degree of ownership of the EAG by investors resident in the foreign country.

(E) *Strategic factors.* The existence of business activities in the foreign country that are material to the achievement of the EAG's overall business objectives.

(iii) *Factors not to be considered.* Any assets, activities, or income attributable to a transfer or transfers disregarded under section 7874(c)(4) are not relevant factors to be considered. In addition, any assets that are temporarily located in a foreign country at any time as part of a plan a principal purpose of which is to avoid the purposes of section 7874 are not relevant factors to be considered.

(2) *Safe harbor*—(i) *Elements.* The EAG will be considered to have substantial business activities, after the acquisition, in the foreign country in which, or under the law of which, the acquiring foreign entity was created or organized, when compared to the total business activities of the EAG, if paragraphs (d)(2)(ii), (iii), and (iv) of this section apply.

(ii) *Employees.* This paragraph (d)(2)(ii) applies if, after the acquisition, the group employees based in the foreign country account for at least 10 percent (by headcount and compensation) of total group employees.

(iii) *Assets.* This paragraph (d)(2)(iii) applies if, after the acquisition, the total value of the group assets located in the foreign country is at least 10 percent of the total value of all group assets.

(iv) *Sales.* This paragraph (d)(2)(iv) applies if, during the testing period, the group sales made in the foreign country accounted for at least 10 percent of total group sales.

(3) *Definitions and application of rules.* For purposes of paragraph (d) of this section—

(i) The term *group employee* means a common law employee of one or more members of the EAG who worked full time (meaning normally 35 or more hours per week) throughout the testing period. An independent contractor performing activities on behalf of an EAG member is not a group employee. A group employee is considered to be based in a country only if the group employee spent more time providing services in such country than in any other country throughout the testing period and continues to provide services in such country immediately after the acquisition. The compensation of a group employee is determined in United States dollars and, in the case of compensation denominated in a foreign currency, translated into United States dollars using the weighted average exchange rate for the taxable year, as defined in § 1.989(b)–1.

(ii) The term *group assets* means tangible property used or held for use in the active conduct of a trade or business by a member of the EAG. An item of tangible personal property is considered to be located in a country only if such item was physically present in such country for more time than in any other country during the testing period. The total value of group assets is determined for purposes of this paragraph on the last day of the testing period, on a gross basis (that is, not reduced by liabilities), measured by either tax book value or fair market value, but not both, in United States dollars translated if necessary at the spot rate determined under the principles of § 1.988–1(d)(1), (2) and (4). Group assets do not include property located in a country by reason of a transfer, or a change of geographic location, pursuant to a plan a principal purpose of which is to avoid the application of section 7874. In addition, intangible assets are not taken into account (in either the numerator or denominator) in calculating the amount of group assets.

(iii) The term *group sales* means sales and the provision of services by members of the EAG, measured by gross receipts from such sales and services, in United States dollars (determined, in

the case of gross receipts denominated in a foreign currency, using the weighted average exchange rate for the taxable year, as defined in Treas. Reg. § 1.989(b)–1). A group sale is considered to be made in a country only if the services, goods or other property transferred by such sale are sold for use, consumption or disposition in such country.

(iv) If one or more members of the EAG own capital or profits interests in a partnership, the proportionate amount of activities, employees, assets, income and sales of such partnership are considered to be activities, employees, assets, income and sales of the member or members of the EAG. A partner's proportionate share shall be determined under the rules and principles of sections 701 through 706 and the regulations thereunder.

(v) The term *testing period* means the 12 month period ending on the last day of the EAG's monthly or quarterly management accounting period in which the acquisition is completed and the term *after the acquisition* means, for purposes of paragraphs (d)(1)(i) and (d)(2)(ii) and (iii) of this section, the last day of the testing period.

(4) *Examples.* The application of paragraph (d)(1) of this section is illustrated by the following examples of business activities of an EAG in a foreign country after an acquisition described in section 7874(a)(2)(B)(i). In each example, the acquiring foreign entity is incorporated in Country A. Paragraph (d)(2) of this section does not apply to any of the examples. The examples are not intended to allow any inferences to be drawn as to whether the presence or absence, in a particular case, of one or more facts described in an example is determinative as to whether an EAG does, or does not, have substantial business activities in the relevant foreign country when compared to the total business activities of the EAG. The examples read as follows:

*Example 1. Administrative activities and some customer services.*—(i) *Facts.* Group employees based in Country A regularly perform administrative, back office services for other EAG members, and regularly provide customer service globally via telephone and e-mail at a communications center located in Country A. After the acquisition, fewer than 2% of group employees are based in Country A. Less than 3% of group sales were made in Country A in the 12-month period ending on the date of the acquisition. The total value of group assets located in Country A on the date of the acquisition is approximately 2% of total group assets. None of the EAG's senior managers are based in Country A.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG does not have substantial business activities in Country A when compared to the total business activities of the EAG.

*Example 2. Manufacturing in foreign country.*—(i) *Facts.* EAG members own and have continuously operated a manufacturing facility and warehouses in Country A for several years prior to the acquisition. The goods produced in Country A represented approximately 2% of the total value of the EAG's production of finished goods in the 12-month period ending on the date of the acquisition. Group employees based in Country A also regularly perform back office services for other EAG members. Fewer than 5% of group employees were based in Country A during the 12-month period ending after the acquisition. Less than 2% of group sales were made in Country A during the 12-month period ending after the acquisition. The total value of group assets located in Country A after the acquisition is approximately 4% of total group assets. None of the EAG's senior managers are based in Country A.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG does not have substantial business activities in Country A when compared to the total business activities of the EAG.

*Example 3. Financial services group; real estate in foreign country.*—(i) *Facts.* The EAG's main line of business is financial services. Group employees based in Country A regularly perform back office services for other EAG members. Fewer than 5% of group employees were based in Country A during the 12-month period ending on the date of the acquisition. Less than 3% of group sales were made in Country A during the same period. However, the total value of group assets located in Country A after the acquisition is more than 10% of the value of total group assets, due to the fact that EAG members purchased a substantial amount of commercial and residential real estate in Country A during the 24 months preceding the acquisition. The management of the real estate is performed by an unrelated independent agent. Most of the EAG's senior managers are based outside Country A. The EAG's real estate portfolio in Country A was not acquired pursuant to a strategic plan for one or more of the EAG's worldwide lines of business, nor are the EAG's business activities in Country A material to the achievement of the EAG's overall business objectives.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG does not have substantial business activities in Country A when compared to the total business activities of the EAG.

*Example 4. Foreign group merging with larger U.S. group.*—(i) *Facts.* The Country A corporation that is the parent entity in the EAG acquired a domestic corporation and its subsidiaries pursuant to a merger agreement. Before the merger, the stock of both the Country A corporation and the domestic corporation was publicly traded in their respective countries of incorporation. The two groups were competitors in the same global line of business for many years preceding the merger. The merger was prompted by a third group's attempt to obtain control of the domestic corporation and its subsidiaries without the consent of the management of the domestic corporation. After the merger, the Country A corporation is more than 60% owned by former shareholders of the domestic corporation, due to the fact that the domestic corporation was significantly more valuable than the Country A corporation. After the merger, the stock of the Country A corporation is publicly traded on stock exchanges in both Country A and the United States. Group employees based in Country A perform all of the functions involved in the EAG's overall business activities, including headquarters and senior management functions. After the merger, approximately 11% of group employees are based in Country A, the total value of group assets located in Country A is approximately 10% of the value of total group assets, and the estimated percentage of group sales that will be made in Country A during the year following the merger is approximately 7%.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG has substantial business activities in Country A when compared to the total business activities of the EAG.

*Example 5. Relocation of business to foreign country.*—(i) *Facts.* The EAG's business involves advanced technology. The controlling shareholders of the Country A corporation that is the parent entity in the EAG, and the senior managers of the EAG, are resident in Country A. The controlling shareholders originally established DC, a domestic corporation, which established its head office in City B in the United States, where a leading institute of technology is located. Part of DC's business strategy was to hire research personnel who had been trained at the institute of technology and had settled in City B. DC hired 10 researchers who worked at DC's premises in City B. DC also established FS, a wholly owned Country A subsidiary, which hired research personnel in Country A to perform research and product development functions at FS's premises in Country A. Subsequently, the senior managers and controlling shareholders adopted a new business strategy involving the closure of the U.S. operations and the transfer of DC's business and FS's stock to FP, a new Country A corporation, with the result of centering the EAG's business in Country A. Pursuant to the new strategy, DC terminated the employment of seven researchers and the lease on its City B premises, relocated the other three researchers from City B to Country A, and transferred its remaining assets, including the stock of FS, to FP in exchange for more than 80% of the stock of FP. After the acquisition, substantially all of the group employees were based in Country A, and substantially all of the group assets were located in Country A.

(ii) *Conclusion.* In light of all the facts and circumstances, after the acquisition, the EAG has substantial business activities in Country A when compared to the total business activities of the EAG.

(e) *Acquisition by publicly traded foreign partnership*—(1) *Treatment as a*

*foreign corporation.* For purposes of applying section 7874(a)(2)(B) and this section, a publicly traded foreign partnership shall be treated as a foreign corporation created or organized in, or under the laws of, the foreign country in which, or under the laws of which, such partnership was created or organized, and interests in such partnership shall be treated as stock of such foreign corporation. In determining whether the publicly traded foreign partnership is a surrogate foreign corporation, the publicly traded foreign partnership will be treated as a member of the EAG, if the requirements of section 7874(c)(1) are met. If this paragraph is applicable and the provisions of section 7874(a)(2)(B) are satisfied such that the foreign entity making the acquisition is a surrogate foreign corporation to which section 7874(b) applies, the foreign entity shall be treated as a domestic corporation for purposes of the Internal Revenue Code. *See* paragraph (e)(3) of this section for the deemed treatment of the change in form from a foreign partnership to a domestic corporation. If this paragraph is applicable and the provisions of section 7874(a)(2)(B) are satisfied such that the foreign entity making the acquisition is a surrogate foreign corporation to which section 7874(b) does not apply, the foreign entity shall continue to be a foreign partnership for purposes of the Internal Revenue Code, but the tax treatment of the expatriated entity shall be governed by section 7874(a)(1). If this paragraph is applicable, but the provisions of section 7874(a)(2)(B) are not satisfied such that the foreign partnership making the acquisition is not a surrogate foreign corporation, the status of the publicly traded foreign partnership will not be affected by section 7874 or § 1.7874–2T.

(2) *Publicly traded foreign partnership.* For purposes of this section, the term *publicly traded foreign partnership* means any foreign partnership that would, but for the application of section 7704(c), be treated as a corporation under section 7704 at any time during the two-year period following the partnership's completion of an acquisition described in section 7874(a)(2)(B)(i).

(3) *Deemed treatment of change from foreign partnership to domestic corporation.* Except for purposes of determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B) and § 1.7874–2T, a foreign partnership that is treated as a domestic corporation pursuant to the application of paragraph (e)(1) of this section and the application of section 7874(b) and § 1.7874–2T shall, immediately before commencement of the acquisition, be treated as transferring all of its assets and liabilities to a newly formed domestic corporation in exchange for the stock of the domestic corporation, and distributing such stock to its partners in liquidation of their interests in the partnership. The tax treatment of the transaction shall be determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(4) *Disregard of deemed acquisition.* For purposes of paragraph (e)(1) of this section, a publicly traded foreign partnership's deemed acquisition of assets and liabilities under § 1.708–1(b)(4) is not a direct or indirect acquisition of properties to which section 7874(a)(2)(B)(i) could apply.

(5) *Examples.* The application of this paragraph is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003, and that any foreign partnership referred to in an example is not treated as a corporation under section 7704. The examples read as follows:

*Example 1. Foreign hybrid entity; public trading of ownership interests on stock market following triangular merger.*—(i) *Facts.* The stock of DP, a domestic corporation, is publicly traded on stock exchange SE. Pursuant to a plan, DP and an unrelated person form a foreign subsidiary entity, FQ, under the laws of foreign country X, transferring a minimal amount of cash to FQ in the process. DP owns 99.9% of FQ and the unrelated party owns 0.1% of FQ. FQ is a limited liability company and is a foreign eligible entity under § 301.7701–2. FQ makes an election under § 301.7701–3 to be treated as a partnership for Federal income tax purposes as of the date of its formation. FQ forms a wholly owned domestic corporation, DS, under the laws of State A. Under a merger agreement and State A law, DS merges into DP,with DP surviving the merger as a wholly owned subsidiary of FQ and the former shareholders of DP receiving ownership interests in FQ in exchange for their DP stock. On the day of the merger, the stock of DP ceases to be listed on stock exchange SE. Trading of ownership interests of FQ on stock exchange SE commences on the day after the day of the merger. FQ, however, is not treated as a corporation under section 7704, due to the application of section 7704(c). After the acquisition, the corporate group owned by FQ does not have substantial business activities in foreign country X when compared to its total business activities.

(ii) *Analysis.* FQ is a publicly traded foreign partnership under paragraph (e)(1) of this section. For purposes of determining whether FQ is a surrogate foreign corporation under section 7874(a)(2)(B), FQ is considered to be a foreign corporation rather than a foreign partnership, and ownership interests in FQ are considered to be stock of FQ. Therefore, on the basis of these facts, FQ is a surrogate foreign corporation because all of the conditions stated in section 7874(a)(2)(B) are satisfied. Because the former shareholders of DP hold more than 80% of FQ's ownership interests, FQ is treated under section 7874(b) as a domestic corporation for purposes of the Internal Revenue Code. In addition, the former shareholders of DP are treated as having received stock of domestic corporation FQ in exchange for their stock of DP.

*Example 2. Substantial business activities of the EAG in the foreign country of incorporation.*—(i) *Facts.* The facts are the same as in *Example 1* except that, after the acquisition, the EAG that includes FQ has substantial business activities in foreign country X when compared to the total business activities of the EAG under the criteria set forth in paragraph (d) of this section.

(ii) *Analysis.* For purposes of determining whether FQ is a surrogate foreign corporation under section 7874(a)(2)(B), FQ is considered to be a foreign corporation rather than a foreign partnership, and ownership interests in FQ are considered to be stock of FQ. On the basis of these facts, FQ is not a surrogate foreign corporation, because, after the acquisition, the EAG that includes FQ has substantial business activities in foreign country X when compared to the total business activities of the EAG. Therefore, section 7874 does not apply to the acquisition, and the status of FQ as a foreign partnership is unaffected.

*Example 3. Acquisition by publicly traded foreign partnership owned by former shareholders and unrelated persons.*—(i) *Facts.* The facts are the same as in Example 1 except that, at the time of the merger transaction, unrelated persons who did not own any stock of DP transfer stock of a foreign corporation to FQ in exchange for 25% of the ownership interests in FQ. Former shareholders of DP receive 75% of the ownership interests in FQ.

(ii) *Analysis.* For purposes of determining whether FQ is a surrogate foreign corporation under section 7874(a)(2)(B), FQ is considered to be a foreign corporation rather than a foreign partnership, and ownership interests in FQ are considered to be stock of FQ. Therefore, on the basis of these facts, and taking into account the provisions of section 7874(c)(4), FQ is a surrogate foreign corporation, because all of the conditions stated in section 7874(a)(2)(B) are satisfied. Because the former shareholders of DP hold less than 80% of FQ's ownership interests, FQ is not treated under section 7874(b) as a domestic corporation for purposes of the Internal Revenue Code. Rather, FQ is a foreign partnership for purposes of the

Internal Revenue Code, and section 7874(a)(1) applies in determining the Federal income tax liability of DP and any other expatriated entity (as defined in section 7874(a)(2)).

(f) *Options and similar interests treated as stock of the foreign acquiring corporation*—(1) *General rule.* For purposes of section 7874(a)(2)(B)(ii), options and interests that are similar to options held by a person by reason of holding stock in the domestic corporation or a capital or profits interest in the domestic partnership described in section 7874(a)(2)(B)(i) shall be treated as exercised. The prior sentence shall apply, however, only to the extent that the effect of such exercise is to treat the foreign entity that has made the acquisition described in section 7874(a)(2)(B)(i) as a surrogate foreign corporation under section 7874(a)(2)(B).

(2) *Interests that are similar to options.* For purposes of paragraph (f)(1) of this section, an interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.

(3) *Example.* The application of this paragraph is illustrated by the following example. It is assumed that the transaction in the example occurs after March 4, 2003. The example reads as follows:

*Example. Convertible bonds treated as stock of foreign corporation.*—(i) *Facts.* DT, a domestic corporation with 80 shares of stock issued and outstanding, is owned by a group of individuals. FA, a foreign corporation unrelated to DT, has 20 shares of stock issued and outstanding. Pursuant to a plan, the shareholders of DT transfer all of their shares of DT to FA in exchange for 25 newly issued shares of FA stock (with a value of $25x) and $55x of FA bonds that are convertible at the election of the holder into 55 shares of FA stock, for no additional consideration, at any time during the ensuing 5-year period. After the acquisition, the EAG that includes FA does not have substantial business activities in FA's country of incorporation when compared to the total business activities of the EAG.

(ii) *Analysis.* FA has indirectly acquired substantially all the properties held directly or indirectly by DT pursuant to a plan. Before the application of this paragraph (f), the former shareholders of DT own 25 shares of FA stock by reason of holding stock in DT. Accordingly, the section 7874(a)(2)(B)(ii) fraction would be 25/45, the resulting percentage would be 55%, and FA would not be a surrogate foreign corporation. Pursuant to paragraph (f)(2) of this section, the FA convertible bonds issued to the former shareholders of DT are treated as interests that are similar to options. As a result, and pursuant to paragraph (f)(1) of this section, the convertible bonds are treated as being converted into 55 shares of FA stock for purposes of section 7874(a)(2)(B)(ii). Therefore, the section 7874(a)(2)(B)(ii) fraction is 80/100, the resulting percentage is 80% and FA is a surrogate foreign corporation. In addition, pursuant to section 7874(b), FA is treated as a domestic corporation.

(g) *Change from foreign to domestic status.*—(1) *Conversion*—(i) *General rule.* Except for purposes of determining whether it is a surrogate foreign corporation under section 7874(a)(2)(B) and § 1.7874–2T, the conversion of a foreign corporation to a domestic corporation under section 7874(b) shall, immediately before commencement of the acquisition described in section 7874(a)(2)(B)(i), be treated as a reorganization described in section 368(a)(1)(F). For the consequences of the conversion, *see* § 1.367(b)–2(f). *See also* § 1.367(b)–3. The tax treatment of all aspects of the transaction other than such conversion shall be determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine.

(ii) *Example.* The following example illustrates the application of paragraph (g)(1)(i) of this section. It is assumed that the transaction in the example occurs after March 4, 2003. The example reads as follows:

*Conversion treated as reorganization under section 368(a)(1)(F).*—(i) *Facts.* DT, a domestic corporation is owned by a group of individuals. FA, a foreign corporation unrelated to DT which has been conducting a trade or business for several years, has 20 shares of stock issued and outstanding. Pursuant to a plan, the shareholders of DT transfer all of their shares of DT to FA in exchange for 80 newly issued shares of FA stock. After the acquisition, the EAG that includes FA does not have substantial business activities in FA's country of incorporation when compared to the total business activities of the EAG.

(ii) *Analysis.* FA has indirectly acquired substantially all the properties held directly or indirectly by DT pursuant to a plan. After the acquisition, the former shareholders of DT own 80 shares of FA stock by reason of holding stock in DT. Accordingly, the section 7874(a)(2)(B)(ii) fraction is 80/100, the resulting percentage is 80%, and FA is a surrogate foreign corporation. In addition, pursuant to section 7874(b), FA is treated as a domestic corporation. Other than for purposes of determining whether FA is a surrogate foreign corporation, the conversion of FA from a foreign corporation to a domestic corporation shall, immediately before FA's acquisition of the DT stock, be treated as a reorganization under section 368(a)(1)(F). See §§ 1.367(b)–2(f) and 1.367(b)–3. The tax treatment of all other aspects of the transaction, including the acquisition of the DT stock by FA, is determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine.

(2) *Entity classification.* An entity that is treated as a domestic corporation under section 7874(b) is not an eligible entity as defined in § 301.7701–3(a) of this chapter and therefore may not elect noncorporate status.

(3) *Time of determination.* Subject to the application of the step transaction doctrine and section 7874(c)(4), the determination of whether a foreign entity is a surrogate foreign corporation is made immediately after completion of the acquisition described in section 7874(a)(2)(B)(i), except as provided in paragraphs (d)(3)(v) and (e)(2) of this section. A foreign entity that is treated as a domestic corporation under section 7874(b) shall continue to be treated as a domestic corporation without regard to whether the provisions of section 7874(a)(2)(B)(ii) and (iii) are satisfied at a later time.

(h) *Nonapplication of section 367*—(1) *General rule.* If section 7874(b) applies to a surrogate foreign corporation, section 367 shall not apply to the transfer of stock or other property to such entity as part of the acquisition described in section 7874(a)(2)(B)(i).

(2) *Example.* The following example illustrates the application of paragraphs (g) and (h)(1) of this section. It is assumed that the transaction in the example occurs after March 4, 2003. The example reads as follows:

*Example. Conversion of foreign corporation to domestic corporation.*—(i) *Facts.* FP, a newly formed foreign corporation, acquires pursuant to a plan substantially all of the stock of DX, a domestic corporation, by issuing its stock to the owners of DX in exchange for their DX stock. The former owners of DX, all of whom are U.S. persons, hold more than 80% of the stock of FP by reason of their ownership of DX stock. The EAG that includes FP does not have substantial business activities in FP's country of incorporation after the acquisition when compared to the total business activities of the EAG.

(ii) *Analysis.* FP is a surrogate foreign corporation under section 7874(a)(2)(B). Under section 7874(b), FP is treated as a domestic corporation for purposes of the Internal Revenue Code. In addition, the former owners of DX are not subject to section 367 with respect to the transfer of their DX stock to FP.

(i) [*Reserved.*]

(j) *Effective date.* This section shall apply to acquisitions completed on or after June 6, 2006. However, taxpayers may apply this section to acquisitions completed prior to that date, but must apply it consistently to all acquisitions within its scope.

Approved: May 22, 2006.

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury.*

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## ENVIRONMENTAL PROTECTION AGENCY

### 40 CFR Part 52

**[EPA–R05–OAR–2005–MI–0001; FRL–8176–6]**

### Approval and Promulgation of Air Quality Implementation Plans; Michigan

**AGENCY:** Environmental Protection Agency (EPA).

**ACTION:** Final rule.

**SUMMARY:** EPA is approving a June 17, 2005, Michigan petition for exemptions from the Reasonably Available Control Technology (RACT) and New Source Review (NSR) requirements for major sources of nitrogen oxides ($NO_X$). The petition is for sources in six of Michigan's eight-hour ozone nonattainment areas, which comprise eleven counties. EPA proposed approval of the petition in a January 5, 2006 rulemaking action. Section 182(f) of the Clean Air Act allows this exemption for areas where additional reductions in $NO_X$ will not contribute to attainment of the ozone standard. The Grand Rapids, Kalamazoo/Battle Creek, Lansing/East Lansing, Benzie County, Huron County, and Mason County nonattainment areas will each receive an exemption.

**DATES:** This final rule is effective on July 6, 2006.

**ADDRESSES:** EPA has established a docket for this action under Docket ID No. EPA–R05–OAR–2005–0001. All documents in the docket are listed on the *www.regulations.gov* Web site. Although listed in the index, some information is not publicly available, i.e., Confidential Business Information (CBI) or other information whose disclosure is restricted by statute. Certain other material, such as copyrighted material, is not placed on the Internet and will be publicly available only in hard copy form. Publicly available docket materials are available either electronically through *http://www.regulations.gov* or in hard copy at the Environmental Protection Agency, Region 5, Air and Radiation Division, 77 West Jackson Boulevard, Chicago, Illinois 60604. This facility is open from 8:30 a.m. to 4:30 p.m., Monday through Friday, excluding Federal holidays. We recommend that you telephone Matt Rau, Environmental Engineer, at (312) 886–6524 before visiting the Region 5 office.

**FOR FURTHER INFORMATION CONTACT:** Matt Rau, Environmental Engineer, Criteria Pollutant Section, Air Programs Branch (AR–18J), U.S. Environmental Protection Agency, Region 5, 77 West Jackson Boulevard, Chicago, Illinois 60604, (312) 886–6524, *rau.matthew@epa.gov.*

**SUPPLEMENTARY INFORMATION:** Throughout this document whenever "we," "us," or "our" is used, we mean EPA. This supplementary information section is arranged as follows:

I. What Is EPA's Analysis of the Supporting Materials?
II. What Are the Environmental Effects of These Actions?
III. What Is EPA's Response to Comments?
IV. What Action Is EPA Taking Today?
V. Statutory and Executive Order Reviews

#### I. What Is EPA's Analysis of the Supporting Materials?

Michigan submitted the 2002–04 monitoring data for the six ozone nonattainment areas. The eight-hour ozone concentrations for these areas were all below the National Ambient Air Quality Standard (NAAQS)for ozone. EPA records indicate the 2003–05 monitoring data is also below the eight-hour ozone NAAQS for all six areas. Michigan has not implemented $NO_X$ control provisions in the areas.

EPA's January 14, 2005 document, "Guidance on Limiting Nitrogen Oxides Requirements Related to 8-Hour Ozone Implementation" gives the requirements for demonstrating that further $NO_X$ reduction in an ozone nonattainment area will not contribute to ozone attainment. The guidance provides that three consecutive years of monitoring data below the standard in areas that have not implemented $NO_X$ controls adequately demonstrates that additional $NO_X$ reductions will not aid attainment. EPA's approval of the petition is granted on a contingent basis. Michigan must continue to monitor the ozone levels in the areas. Each of the six areas receives its own exemption. If an area violates the standard, EPA will remove the exemption for that area.

#### II. What Are the Environmental Effects of These Actions?

Nitrogen oxides are a precursor in ozone formation. Volatile organic compounds (VOC) are another ozone precursor. The photochemical reactions that form ozone are complex. Reducing $NO_X$ (NO and $NO_2$) emissions will not always reduce ozone levels. When the ratio of NO to VOC emissions is high, the NO will react with ozone ($O_3$) to form $NO_2$ and oxygen ($O_2$). In this environment, the $NO_2$ will react with hydroxyl (OH) radicals instead of forming ozone. A decrease in $NO_X$ emissions would cause an increase in ozone formation when these conditions exist. This effect is usually localized.

Because of this chemical reaction, the section 182(f) exemptions should not interfere with attainment of the standard NAAQS for ozone in the six Michigan ozone nonattainment areas. The state demonstrated that the areas were able to hold ozone levels under the NAAQS without employing $NO_X$ controls. Thus, additional $NO_X$ controls would not be expected to contribute to attainment. Ozone levels are expected to remain below the standard which will protect human health. If a violation occurs in one of the areas, EPA will remove the exemption for that area and will require additional control measures.

#### III. What Is EPA's Response to Comments?

EPA received one comment on the January 5, 2006 (71 FR 577–579), proposed approval of Michigan's petition. That comment came from the New York State Department of Environmental Conservation (New York). New York was concerned that EPA did not evaluate the impact of the $NO_X$ waivers on its ozone nonattainment areas. It cited the results of ozone contribution modeling from another EPA program, the Clean Air Interstate Rule. The contribution modeling shows a link between state-wide Michigan $NO_X$ and VOC emissions and nineteen counties, including the New York ozone nonattainment counties of Erie, Richmond, and Suffolk.

In considering this petition, EPA did not evaluate the impact of the $NO_X$ waivers on downwind ozone nonattainment areas. This is not a part of the process for evaluating section 182(f) waiver requests. The $NO_X$ emission reductions required from Michigan under other EPA programs are not affected by granting of the waivers. Also, reductions of other ozone precursors, such as VOC, are unaffected by this action. If called for under other programs, Michigan will be required to reduce its state-wide emissions to address its contribution to nonattainment counties in other states. The Clean Air Interstate Rule will address the specific concern New York expressed by requiring ozone precursor reductions in Michigan and other states