

applied to reduce the net operating loss carryovers (if any) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed under section 381(a) and (c)(1). See also Rev. Rul. 72-421 (1972-2 C.B. 166) (see § 601.601(d)(2) of this chapter).

(2) *Reduction of capital loss carryovers.* After the application of paragraph (b)(4)(i)(B)(1) of this section, any remaining excess earnings and profits amount shall be applied to reduce the capital loss carryovers (if any) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed under section 381(a) and (c)(3).

(3) *Reduction of basis.* After the application of paragraph (b)(4)(i)(B)(2) of this section, any remaining excess earnings and profits amount shall be applied to reduce (but not below zero) the basis of the assets (other than dollar-denominated money) of the foreign acquired corporation that are acquired by the domestic acquiring corporation. Such remaining excess earnings and profits amount shall be applied to reduce the basis of such assets in the following order: first, tangible depreciable or depletable assets, according to their class lives (beginning with those assets with the shortest class life); second, other non-inventory tangible assets; third, intangible assets that are amortizable; and finally, the remaining assets of the foreign acquired corporation that are acquired by the domestic acquiring corporation. Within each of these categories, if the total basis of all assets in the category is greater than the excess earnings and profits amount to be applied against such basis, the taxpayer may choose to which specific assets in the category the basis reduction first applies.

(C) *Notification.* The exchanging shareholder shall elect to apply the rules of this paragraph (b)(4)(i) by attaching a statement of its election to its section 367(b) notice. See § 1.367(b)-1(c) For the rules concerning filing a section 367(b) notice.

(D) *Example.* The following example illustrates the rules of this paragraph (b)(4)(i):

Example— (i) *Facts.* DC, a domestic corporation, owns all of the outstanding stock

of FC, a foreign corporation. The stock of FC has a value of \$100, and DC has a basis of \$80 in such stock. The assets of FC are one parcel of land with a value of \$60 and a basis of \$30, and tangible depreciable assets with a value of \$40 and a basis of \$80. FC has no net operating loss carryovers or capital loss carryovers. The all earnings and profits amount with respect to the FC stock owned by DC is \$30, of which \$19 is described in section 1248(a) and the remaining \$11 is not (for example, because it was earned prior to 1963). In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled. Rather than including in income as a deemed dividend the all earnings and profits amount of \$30 as provided in § 1.367(b)-3(b)(3)(i), DC instead elects taxable exchange treatment under paragraph (b)(4)(i)(A) of this section.

(ii) *Result.* DC recognizes the \$20 of gain it realizes on its stock in FC. Of this \$20 amount, \$19 is included in income by DC as a dividend pursuant to section 1248(a). (For the source of the remaining \$1 of gain recognized by DC, see section 865. For the treatment of the \$1 for purposes of the foreign tax credit limitation, see generally section 904(d)(2)(A)(i).) Because the transaction is described in section 332 and because the all earnings and profits amount with respect to the FC stock held by DC (\$30) exceeds by \$10 the income recognized by DC (\$20), the attribute reduction rules of paragraph (b)(4)(i)(B) of this section apply. Accordingly, the \$10 excess earnings and profits amount is applied to reduce the basis of the tangible depreciable assets of FC, beginning with those assets with the shortest class lives. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b) (which is applied taking into account the basis reduction prescribed by paragraph (b)(4)(i)(A)(3) of this section) DC takes a basis of \$30 in the land and \$70 in the tangible depreciable assets that it receives from FC.

(ii) *Effective date.* This paragraph (b)(4) applies for section 367(b) exchanges that occur between February 23, 2000, and February 23, 2001.

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

[T.D. 8863, 65 FR 3588, Jan. 24, 2000]

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

(a) *Scope.* This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of

the stock or assets of a foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1)(B), (C), (D), (E), (F) or (G). This section applies notwithstanding that the foreign acquiring corporation and the foreign acquired corporation may be the same corporation (such as in a section 368(a)(1)(E) reorganization). See § 1.367(a)-3(b)(2) for additional rules that may apply.

(b) *Income inclusion.* If an exchange is described in paragraph (b)(1)(i), (2)(i) or (3) of this section, the exchanging shareholder shall include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

(1) *Exchange that results in loss of status as section 1248 shareholder—(i) Rule.* An exchange is described in this paragraph (b)(1)(i) if—

(A) Immediately before the exchange, the exchanging shareholder is—

(1) A United States person that is a section 1248 shareholder with respect to the foreign acquired corporation; or

(2) A foreign corporation, and a United States person is a section 1248 shareholder with respect to such foreign corporation and with respect to the foreign acquired corporation; and

(B) Either of the following conditions is satisfied—

(1) Immediately after the exchange, the stock received in the exchange is not stock in a corporation that is a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder; or

(2) Immediately after the exchange, the foreign acquiring corporation or the foreign acquired corporation (if any, such as in a transaction described in section 368(a)(1)(B) and/or section 351), is not a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (b)(1):

Example 1—(i) Facts. FC1 is a foreign corporation that is owned, directly and indirectly (applying the ownership rules of section 958), solely by foreign persons. DC is a domestic corporation that is unrelated to

FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. Thus, under § 1.367(b)-2(a) and (b), DC is a section 1248 shareholder with respect to FC2, and FC2 is a controlled foreign corporation. Under § 1.367(b)-2(c)(1), the section 1248 amount attributable to the stock of FC2 held by DC is \$20. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and assumes all of the liabilities of FC2 in exchange for FC1 voting stock. The FC1 voting stock received does not represent more than 50 percent of the voting power or value of FC1's stock. FC2 distributes the FC1 stock to DC, and the FC2 stock held by DC is canceled.

(ii) *Result.* FC1 is not a controlled foreign corporation immediately after the exchange. As a result, the exchange is described in paragraph (b)(1)(i) of this section. Under paragraph (b) of this section, DC must include in income, as a deemed dividend from FC2, the section 1248 amount (\$20) attributable to the FC2 stock that DC exchanged.

Example 2—(i) Facts. The facts are the same as in *Example 1*, except that the voting stock of FC1, which is received by FC2 in exchange for its assets and distributed by FC2 to DC, represents more than 50 percent of the voting power of FC1's stock under the rules of section 957(a).

(ii) *Result.* Paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount, because FC1 is a controlled foreign corporation as to which DC is a section 1248 shareholder immediately after the exchange.

Example 3—(i) Facts. The facts are the same as in *Example 1*, except that FC2 receives and distributes voting stock of FP, a foreign corporation that is in control (within the meaning of section 368(c)) of FC1, instead of receiving and distributing voting stock of FC1.

(ii) *Result.* For purposes of section 367(a), the transfer is an indirect stock transfer subject to section 367(a). See § 1.367(a)-3(d)(1)(iv). Accordingly, DC's exchange of FC2 stock for FP stock under section 354 will be taxable under section 367(a) (and section 1248 will be applicable) if DC fails to enter into a gain recognition agreement in accordance with § 1.367(a)-8. Under § 1.367(a)-3(b)(2), if DC enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder, as well as section 367(a). If FP and FC1 are controlled foreign corporations as to which DC is a (direct or indirect) section 1248 shareholder immediately after the reorganization, then the section 367(b) result is the same as in *Example 2*—that is, paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount. Under these circumstances, the amount of the gain recognition agreement would equal the amount of the gain realized

on the indirect stock transfer. If FP or FC1 is not a controlled foreign corporation as to which DC is a (direct or indirect) section 1248 shareholder immediately after the exchange, then the section 367(b) result is the same as in *Example 1*—that is, DC must include in income, as a deemed dividend from FC2, the section 1248 amount (\$20) attributable to the FC2 stock that DC exchanged. Under these circumstances, the amount of the gain recognition agreement would equal the amount of the gain realized on the indirect stock transfer, less the \$20 section 1248 amount inclusion.

Example 4—(i) Facts. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC2 owns various assets including all of the outstanding stock of FC2, a foreign corporation. The stock of FC2 has a value of \$100, and DC2 has a basis of \$30 in such stock. The section 1248 amount attributable to the FC2 stock held by DC2 is \$20. DC2 does not own any other stock in a foreign corporation. FC1 is a foreign corporation that is unrelated to DC1, DC2 and FC2. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and liabilities of DC2 in exchange for FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes the FC1 stock to DC1, and the DC2 stock held by DC1 is canceled. DC1 properly files a gain recognition agreement under § 1.367(a)-8 to qualify for non-recognition treatment under section 367(a) with respect to DC2's transfer of the FC2 stock to FC1. See § 1.367(a)-8(f)(2).

(ii) *Result.* Pursuant to paragraph (b)(1)(i)(A) of this section, DC2 is the exchanging shareholder that is a section 1248 shareholder with respect to FC2, the foreign acquired corporation. Immediately after the exchange, DC2 is not a section 1248 shareholder with respect to FC1, the corporation whose stock is received in the exchange (because the DC2 stock is canceled). Thus, paragraph (b)(1)(i)(B) of this section is satisfied and, as a result, paragraph (b)(1)(i) of this section applies to DC2's section 361 exchange of FC2 stock. Accordingly, under paragraph (b) of this section, DC2 must include in income, as a deemed dividend from FC2, the section 1248 amount (\$20) attributable to the FC2 stock that DC2 exchanges. This result arises without regard to whether FC1 and FC2 are controlled foreign corporations immediately after the exchange. For the tax treatment of DC2's transfer of assets (other than stock) to FC1, see sections 367(a)(1) and (a)(3), and the regulations thereunder. Because the exchange is also described in section 361(a) or (b), see section 367(a)(5) and any regulations thereunder. If any of the assets transferred are intangible assets, see section 367(d) and the regulations thereunder.

(2) *Receipt by exchanging shareholder of preferred or other stock in certain instances—(i) Rule.* An exchange is described in this paragraph (b)(2)(i) if—

(A) Immediately before the exchange, the foreign acquired corporation and the foreign acquiring corporations are not members of the same affiliated group (within the meaning of section 1504(a), but without regard to the exceptions set forth in section 1504(b), and substituting the words “more than 50” in place of the words “at least 80” in sections 1504(a)(2)(A) and (B));

(B) Immediately after the exchange, a domestic corporation meets the ownership threshold specified by section 902(a) or (b) such that it may qualify for a deemed paid foreign tax credit if it receives a distribution from the foreign acquiring corporation (directly or through tiers); and

(C) The exchanging shareholder receives preferred stock (other than preferred stock that is fully participating with respect to dividends, redemptions and corporate growth) in consideration for common stock or preferred stock that is fully participating with respect to dividends, redemptions and corporate growth, or, in the discretion of the Commissioner or the Commissioner's delegate (and without regard to whether the stock exchanged is common stock or preferred stock), receives stock that entitles it to participate (through dividends, redemption payments or otherwise) disproportionately in the earnings generated by particular assets of the foreign acquired corporation or foreign acquiring corporation.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1—(i) Facts. FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation, and FC2 has no outstanding preferred stock. The value of FC2 is \$100 and DC has a basis of \$50 in the stock of FC2. Under § 1.367(b)-2(c)(1), the section 1248 amount attributable to the stock of FC2 held by DC is \$20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 and, in exchange, DC receives FC1 voting preferred stock that constitutes 10 percent of the voting stock of FC1 for purposes of section 902(a). Immediately after the exchange, FC1 and FC2 are controlled foreign corporations and DC is a section 1248 shareholder of FC1

and FC2, so paragraph (b)(1)(i) of this section does not require inclusion in income of the section 1248 amount.

(ii) *Result.* Pursuant to § 1.367(a)-3(b)(2), the transfer is subject to both section 367(a) and section 367(b). Under § 1.367(a)-3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement in accordance with § 1.367(a)-8. Even though paragraph (b)(1)(i) of this section does not apply to require inclusion in income by DC of the section 1248 amount, DC must nevertheless include the \$20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2)(i) of this section. Thus, if DC enters into a gain recognition agreement, the amount is \$30 (the \$50 gain realized less the \$20 recognized under section 367(b)). If DC fails to enter into a gain recognition agreement, it must include in income under section 367(a)(1) the \$50 of gain realized (\$20 of which is treated as a dividend under section 1248). Section 367(b) does not apply in such case.

Example 2— (i) *Facts.* The facts are the same as in *Example 1*, except that DC owns all of the outstanding stock of FC1 immediately before the transaction.

(ii) *Result.* Both section 367(a) and section 367(b) apply to the transfer. Paragraph (b)(2)(i) of this section does not apply to require inclusion of the section 1248 amount. Under paragraph (b)(2)(i)(A) of this section, the transaction is outside the scope of paragraph (b)(2)(i) of this section because FC1 and FC2 are, immediately before the transaction, members of the same affiliated group (within the meaning of such paragraph). Thus, if DC enters into a gain recognition agreement in accordance with § 1.367(a)-8, the amount of such agreement is \$50. As in *Example 1*, if DC fails to enter into a gain recognition agreement, it must include in income \$50, \$20 of which will be treated as a dividend under section 1248.

Example 3— (i) *Facts.* FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. The section 1248 amount attributable to the stock of FC2 held by DC is \$20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 in exchange for FC1 voting stock that constitutes 10 percent of the voting stock of FC1 for purposes of section 902(a). The FC1 voting stock received by DC in the exchange carries voting rights in FC1, but by agreement of the parties the shares entitle the holder to dividends, amounts to be paid on redemption, and amounts to be paid on liquidation, that are to be determined by reference to the earnings or value of FC2 as of the date of such event, and that are affected by the earnings or value of FC1 only if FC1 becomes insolvent or has insufficient capital surplus to pay dividends.

(ii) *Result.* Under § 1.367(a)-3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement with respect to the transfer of FC2 stock to FC1. Under § 1.367(a)-3(b)(2), the exchange will be subject to the provisions of section 367(b) and the regulations thereunder to the extent that it is not subject to tax under section 367(a)(1). Furthermore, even if DC would not otherwise be required to recognize income under this section, the Commissioner or the Commissioner's delegate may nevertheless require that DC include the \$20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2)(i) of this section.

(3) *Certain recapitalizations.* An exchange pursuant to a recapitalization under section 368(a)(1)(E) shall be deemed to be an exchange described in this paragraph (b)(3) if the following conditions are satisfied—

(i) During the 24-month period immediately preceding or following the date of the recapitalization, the corporation that undergoes the recapitalization (or a predecessor of, or successor to, such corporation) also engages in a transaction that would be described in paragraph (b)(2)(i) of this section but for paragraph (b)(2)(i)(C) of this section, either as the foreign acquired corporation or the foreign acquiring corporation; and

(ii) The exchange in the recapitalization is described in paragraph (b)(2)(i)(C) of this section.

(c) *Exclusion of deemed dividend from foreign personal holding company income—*(1) *Rule.* In the event the section 1248 amount is included in income as a deemed dividend by a foreign corporation under paragraph (b) of this section, such deemed dividend shall not be included as foreign personal holding company income under section 954(c).

(2) *Example.* The following example illustrates the rule of this paragraph (c):

Example— (i) *Facts.* FC1 is a foreign corporation that is owned, directly and indirectly (applying the ownership rules of section 958), solely by foreign persons. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. FC2 owns all of the outstanding stock of FC3, a foreign corporation. Under § 1.367(b)-2(c)(1), the section 1248 amount attributable to the stock of FC3 held by FC2 is \$20. In a reorganization described in section 368(a)(1)(B), FC1 acquires from FC2 all of the stock of FC3 in exchange for FC1 voting stock. The FC1 voting stock received by FC2 does not represent more

than 50 percent of the voting power or value of FC1's stock.

(ii) *Result.* FC1 is not a controlled foreign corporation immediately after the exchange. Under paragraph (b)(1) of this section, FC2 must include in income, as a deemed dividend from FC3, the section 1248 amount (\$20) attributable to the FC3 stock that FC2 exchanged. The deemed dividend is treated as a dividend for purposes of the Internal Revenue Code as provided in §1.367(b)-2(e)(2); however, under this paragraph (c) the deemed dividend is not foreign personal holding company income to FC2.

(d) *Rules for subsequent exchanges—(1) In general.* If income is not required to be included under paragraph (b) of this section in a section 367(b) exchange described in paragraph (a) of this section (non-inclusion exchange) then, for purposes of applying section 367(b) or 1248 to subsequent exchanges and subject to the limitation of §1.367(b)-2(d)(3)(iii) (in the case of a transaction described in §1.367(b)-3), the determination of the earnings and profits attributable to an exchanging shareholder's stock received in the non-inclusion exchange shall include a computation that refers to the exchanging shareholder's pro rata interest in the earnings and profits of the foreign acquiring corporation (and, in the case of a stock transfer, the foreign acquired corporation) that accumulate after the non-inclusion exchange, as well as its pro rata interest in the earnings and profits of the foreign acquired corporation that accumulated before the non-inclusion exchange. See also section 1248(c)(2)(D)(ii). The earnings and profits attributable to the stock received by an exchanging shareholder in the non-inclusion exchange shall not include any earnings and profits of the foreign acquiring corporation that accumulated before the non-inclusion exchange. In the case of a non-inclusion exchange in which the exchanging shareholder is a foreign corporation, this paragraph (d)(1) shall also apply for purposes of determining the earnings and profits attributable to the exchanging foreign corporation's shareholders, as well as for purposes of determining the earnings and profits attributable to the exchanging foreign corporation when applying section 964(e) to subsequent sales or exchanges of the stock of the foreign acquiring corporation.

(2) *Subsequent dispositions by a foreign acquiring corporation.* In the case of an exchange by a foreign acquiring corporation that is subject to section 367(b) or 964(e) and that follows a non-inclusion exchange (as defined in paragraph (d)(1) of this section), the rules of paragraph (d)(1) of this section shall not apply. However, as a result of such a subsequent exchange, proportionate reductions shall be made to the earnings and profits that accumulated before the non-inclusion exchange and that were attributed under paragraph (d)(1) of this section. Such reductions shall be made without regard to whether gain is recognized on the subsequent sale or exchange.

(3) *Examples.* The following examples illustrate the rules of this section:

Example 1—(i) Facts. DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation. FC1 has \$20 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC1's stock in FC1. DC2, a domestic corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. FC2 has \$40 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC2's stock in FC2. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), DC1 transfers all of the stock of FC1 to FC2 in exchange for 40 percent of FC2 stock. DC1 enters into a five-year gain recognition agreement under the provisions of §§1.367(a)-3(b) and 1.367(a)-8 with respect to its transfer of FC1 stock to FC2.

(ii) *Result.* (A) DC1's transfer of FC1 to FC2 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, DC1 is not required to include in income the section 1248 amount attributable to its FC1 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges of FC2 stock, the determination of the earnings and profits attributable to DC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC1 and FC2, and that refers to 100 percent of the \$20 of pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's stock in FC2 will not include any of the \$40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248. However, paragraph (d)(1) of this section does not apply for purposes of

applying section 367(b) or 964(e) to subsequent exchanges of FC1 stock by FC2. For these purposes, the determination of the earnings and profits attributable to FC2's stock in FC1 is made under the principles of section 1248 and, as a result, includes a computation that refers to the \$20 of earnings and profits attributable to FC2's section 1223(2) holding period in the FC1 stock.

(B) In the event FC2 exchanges FC1 stock in a transaction that is subject to section 367(b) or 964(e), a proportionate reduction must be made to the \$20 of earnings and profits that was previously attributed under paragraph (d)(1) of this section to DC1's stock in FC2. Thus, for example, if FC2 sells 50 percent of its FC1 stock (at a time when there have been no other reductions that affect the \$20 of FC1 earnings and profits), paragraph (d)(2) of this section requires DC1 to proportionately reduce the \$20 of earnings and profits that was previously attributed to its FC2 stock (to \$10). This reduction occurs without regard to whether FC2 recognizes gain on its sale of FC1 stock.

Example 2— (i) *Facts.* The facts are the same as in *Example 1*, except that in a reorganization described in section 368(a)(1)(C), FC1 transfers all of its assets to FC2 in exchange for 40 percent of FC2 stock. FC1 then distributes the stock of FC2 to DC1, and the FC1 stock held by DC1 is canceled. None of FC1's assets include stock.

(ii) *Result.* FC2's acquisition of FC1 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, DC1 is not required to include in income the section 1248 amount attributable to its FC1 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges, the determination of the earnings and profits attributable to DC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2, and that refers to 100 percent of the pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's stock in FC2 will not include any of the \$40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248.

Example 3— (i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC3, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation, and FC1 has owned all of the stock of FC3 since FC3's formation. FC3 has \$20 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC1's stock in FC1 and in the section 1248 amount attributable to FC1's stock in FC3. Such earnings and profits are similarly eligible for inclusion as a dividend attributable to FC1's

stock in FC3 under section 964(e). DC2, a domestic corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. FC2 has \$40 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC2's stock in FC2. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), FC1 transfers all of the stock of FC3 to FC2 in exchange for 40 percent of FC2 stock.

(ii) *Result.* (A) FC1's transfer of FC3 to FC2 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, FC1 is not required to include in income the section 1248 amount attributable to its FC3 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges of FC1 stock, the determination of the earnings and profits attributable to DC1's stock in FC1 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2 and FC3, and that refers to 100 percent of the \$20 of pre-reorganization earnings and profits of FC3. The earnings and profits attributable to FC1's stock in FC2 will not include any of the \$40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248. For purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC2 stock, the determination of the earnings and profits attributable to FC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2 and FC3, and that refers to 100 percent of the \$20 of pre-reorganization earnings and profits of FC3. The earnings and profits attributable to FC1's interest in FC2 do not include any of the \$40 of earnings and profits accumulated by FC2 prior to the transaction. However, paragraph (d)(1) of this section does not apply for purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC3 stock by FC2. For these purposes, the determination of the earnings and profits attributable to FC2's stock in FC3 is made under the principles of section 1248 and, as a result, includes a computation that refers to the \$20 of earnings and profits attributable to FC2's section 1223(2) holding period in the FC3 stock.

(B) In the event FC2 exchanges FC3 stock in a transaction that is subject to section 367(b) or 964(e), a proportionate reduction must be made to the \$20 of earnings and profits that was previously attributed under paragraph (d)(1) of this section to DC1's stock in FC1 (for purposes of subsequent application of section 367(b) or 1248) as well as to FC1's stock in FC2 (for purposes of subsequent application of section 367(b) or 964(e)). Thus, for example, if FC2 sells 50 percent of

its FC3 stock (at a time when there have been no other reductions that affect the \$20 of FC3 earnings and profits), paragraph (d)(2) of this section requires DC1 and FC1 to proportionately reduce the \$20 of earnings and profits that was previously attributed to their FC1 and FC2 stock, respectively (to \$10). These reductions occur without regard to whether FC2 recognizes gain on its sale of FC3 stock.

[T.D. 8862, 65 FR 3603, Jan. 24, 2000; 65 FR 66501, Nov. 6, 2000]

§ 1.367(b)-5 Distributions of stock described in section 355.

(a) *In general*—(1) *Scope*. This section provides rules relating to a distribution described in section 355 (or so much of section 356 as relates to section 355) and to which section 367(b) applies. For purposes of this section, the terms *distributing corporation*, *controlled corporation*, and *distributee* have the same meaning as used in section 355 and the regulations thereunder.

(2) *Treatment of distributees as exchanging shareholders*. For purposes of the section 367(b) regulations, all distributees in a transaction described in paragraph (b), (c), or (d) of this section shall be treated as exchanging shareholders that realize income in a section 367(b) exchange.

(b) *Distribution by a domestic corporation*—(1) *General rule*. In a distribution described in section 355, if the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation, the following general rules shall apply—

(i) If the distributee is a corporation, then the controlled corporation shall be considered to be a corporation; and

(ii) If the distributee is an individual, then, solely for purposes of determining the gain recognized by the distributing corporation, the controlled corporation shall not be considered to be a corporation, and the distributing corporation shall recognize any gain (but not loss) realized on the distribution.

(2) *Section 367(e) transactions*. The rules of paragraph (b)(1) of this section shall not apply to a foreign distributee to the extent gain is recognized under section 367(e)(1) and the regulations thereunder.

(3) *Determining whether distributees are individuals*. All distributees in a dis-

tribution described in paragraph (b)(1) of this section are presumed to be individuals. However, the shareholder identification principles of § 1.367(e)-1(d) (including the reporting procedures in § 1.367(e)-1(d)(2) and (3)) shall apply for purposes of rebutting this presumption.

(4) *Applicable cross-references*. For rules with respect to a distributee that is a partnership, trust or estate, see § 1.367(b)-2(k). For additional rules relating to a distribution of stock of a foreign corporation by a domestic corporation, see section 1248(f) and the regulations thereunder. For additional rules relating to a distribution described in section 355 by a domestic corporation to a foreign distributee, see section 367(e)(1) and the regulations thereunder.

(c) *Pro rata distribution by a controlled foreign corporation*—(1) *Scope*. This paragraph (c) applies to a distribution described in section 355 in which the distributing corporation is a controlled foreign corporation and in which the stock of the controlled corporation is distributed pro rata to each of the distributing corporation's shareholders.

(2) *Adjustment to basis in stock and income inclusion*. If the distributee's postdistribution amount (as defined in paragraph (e)(2) of this section) with respect to the distributing or controlled corporation is less than the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) with respect to such corporation, then the distributee's basis in such stock immediately after the distribution (determined under the normal principles of section 358) shall be reduced by the amount of the difference. However, the distributee's basis in such stock shall not be reduced below zero, and to the extent the foregoing reduction would have reduced basis below zero, the distributee shall instead include such amount in income as a deemed dividend from such corporation.

(3) *Interaction with § 1.367(b)-2(e)(3)(ii)*. The basis increase provided in § 1.367(b)-2(e)(3)(ii) shall not apply to a deemed dividend that is included in income pursuant to paragraph (c)(2) of this section.

(4) *Basis redistribution*. If a distributee reduces the basis in the stock of the